

**PROTECTING INVESTORS AND  
FOSTERING EFFICIENT MARKETS:  
A REVIEW OF THE SEC AGENDA**

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**HEARING**  
BEFORE THE  
**COMMITTEE ON FINANCIAL SERVICES**  
**U.S. HOUSE OF REPRESENTATIVES**  
ONE HUNDRED NINTH CONGRESS  
SECOND SESSION

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# **PROTECTING INVESTORS AND FOSTERING EFFICIENT MARKETS: A REVIEW OF THE SEC AGENDA**

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**Thursday, May 25, 2006**

U.S. HOUSE OF REPRESENTATIVES,  
COMMITTEE ON FINANCIAL SERVICES,  
*Washington, D.C.*

The committee met, pursuant to notice, at 1:05 p.m., in room 2128, Rayburn House Office Building, Hon. Richard H. Baker presiding.

Present: Representatives Baker, Paul, Hensarling, Pearce, Price, McHenry, Campbell, Rank, Kanjorski, Sanders, Velazquez, Watt, Ackerman, Hooley, Sherman, Lee, Moore, Hinojosa, Clay, McCarthy, Baca, Miller, Scott, Davis of Alabama, Green, Cleaver, Wasserman-Schultz, and Moore.

Mr. BAKER. [presiding] This meeting of the Committee on Financial Services will come to order. By prior agreement, Ranking Member Frank and I have agreed to limit opening statements to two to a side, and we will proceed with that unanimous consent agreement.

Today we meet under the title of, "Protecting Investors and Fostering Efficient Markets," actually a second day of hearings on the subject. Investor protection and fostering efficient market function are concepts that are not mutually exclusive, and can be both similarly attained.

This Congress has a history of acting when identifying irregularities in the financial marketplace, whether it be the accounting matter, investment banking and analysts, Fannie Mae, all of the matters that have come before the Committee, we have found reason to act, and I believe in most cases, act appropriately.

I wish to bring to the discussion today a new area of concern, because of its impact on our global competitiveness. Although I know some of the witnesses will speak to the concerns relating to executive compensation today, I wish to bring to the debate a discussion of the recent Department of Justice action relative to Milberg Weiss and class action litigation.

The discoveries made in this indictment are, indeed, very troubling, enabling in excess of \$11 million to be paid for basically straw men to file suit on behalf of an identified class. The fees generated from those actions exceeded \$216 million to the affected attorneys. The attorney general bringing the case is quoted as saying, "This case is about protecting the integrity of our justice system,

and class action attorneys and named plaintiffs occupy positions of trust in which they assume responsibility to tell the truth.”

According to industry studies, the Milberg Weiss firm has been the lead, or co-counsel, in approximately 43 percent of class action suits from 1995 to 2005. And that chart is impossible to read, but trust me, that’s what it says. The indictment confirms that this firm alone was responsible for about \$6.5 billion in settlements, and raked in \$1.7 billion more in fees and expenses.

The indictment is troubling, but it brings to the clear forefront that our tort system is in need of significant reform. Our system is increasingly becoming a tool to be manipulated to generate huge cash settlements. Even a quick look at recent trends; the aggregate securities class action settlements skyrocketed from \$500 million in 1997 to over \$9 billion in 2005, which the chart reflects.

To put it in even more perspective, in 2004, the aggregate fees earned by attorneys was approximately \$40 billion. The same year aggregate salaries, which is the subject of some discussion today, for the Fortune 500 in its entirety, was \$5 billion.

In 2005, the average salary for a Forbes CEO had climbed to \$10.9 million. The staggering consequence of the tobacco settlement in Florida resulted in any attorney who had anything to do with the litigation receiving \$233 million. And that’s not per firm, that’s per participating attorney in the settlement.

Ultimately, this money is paid by the corporation, which dilutes shareholder rate of return, and it is of consequence in our ability to compete globally. Firms are choosing to list overseas, and the amount of IPO’s continues to flow out of the country to particularly the London market.

Consequently, Congressman McHenry and I will be introducing legislation later in the week to bring about some reform to this abusive practice, principally in the context of a loser pays recommendation.

I think we should examine compensation at all levels. We should appropriately rebalance equities from time to time. I think the hearing today will bring needed attention to these matters, and I look forward to all members’ statements on this matter. Congressman Frank?

Mr. FRANK. Thank you, Mr. Chairman. And I would ask that all members be allowed to introduce their statements into the record today.

Mr. BAKER. Without objection.

Mr. FRANK. This hearing was called, this second day of hearings, pursuant to rule 11 of the Rules of the House of Representatives, whereby a majority of the minority can insist on a second day of hearings with the witnesses to be called by the minority. We had asked that this be done in the regular order, we were denied, and every member on the minority side signed a letter, the result of which is this hearing.

It is the second day, technically, of hearings with the SEC, and the SEC, as people know, to the credit of Chairman Cox and his colleagues, has begun to move in the area of executive compensation. And those who have argued that there should be no government interference with the setting of compensation, have a quarrel with Chairman Cox and his colleagues if they act on the proposal

that they have put forward, because they are the ones who have initiated this action.

We agree with what they have done, as far as it goes, many of us on our side, and some on the other side. But there is an added element. The bill that I have introduced, and that we will be talking about today, is transparency of the sort that the SEC has asked for, with a few more specifics. But most importantly, giving the shareholders a right to vote.

We are not talking about having the Congress, the SEC, or anybody else set any amount of money. If the stockholders of General Electric want to buy Mr. Welch's newspapers in perpetuity, they can do that. It's their money, if they are selling newspapers being published in 15 years.

But we do think that they ought to vote on that. The problem we have is this; shareholders do not get to vote on the compensation. And indeed, people have said, "Well, if they don't like it, they can get rid of the board of directors." No, they can't in many cases, because the board of directors have, in many cases, a very undemocratic form of election. I have heard it suggested that, "Well, you know, if they don't like it, they can sell their stock." I guess I have said to the people who have said that, "That's right. If you don't like this, you can move to Canada."

But the fact is that presenting shareholders with the option of either sell your stock or take whatever we do, hardly comports with the notion of shareholder democracy. And we do have a serious problem. The great majority of people who run corporations are honest, decent, hard-working people. But the great majority of Americans do not steal, murder, or commit arson. We still have laws against theft, murder, and arson. The fact that the great majority are well-behaved has never been a good argument against dealing with abuses.

And in fact, under this law's mechanism that we are talking about, we would only deal with abuses. Stockholders of a company that is being very well run and whose CEO's and others are being fairly compensated, will routinely vote to ratify it. We don't have an example of excessive stockholder interference with what they shouldn't be doing.

But there have clearly been abuses. Now, we have one—and I want to make the point, too, that what we are talking about here is macro-economically significant. A study at Harvard shows that in the period from 2003 to 2005, the amount of profits from corporations that went to the compensation for the top five officials was 9.8 percent. He had an earlier calculation of 10.3—I want to be accurate—we crossed out 10.3; it's 9.8 percent. 9.8 percent of profits is pretty significant.

And we are talking here about problems that this can cause. In Business Week for this week, it notes that Exxon Mobil has the largest unfunded pension obligation in America. And Lee Raymond has the largest compensation. The \$40 million Mr. Raymond got would have made a dent, at least, in the unfunded obligation. The fact is that we have problems where pensions are underfunded, where health care is being cut back, where wages for working people are frozen, and yet we have some CEO's getting enormous amounts of money.

And one of the problems we have is this. No study I have seen—and we have looked very hard—shows any correlation between CEO compensation and any conceivable metric of corporate success. There are some aggregate figures—this isn't an aggregate bill—we're not asking all stockholders to vote on the total amount of compensation, we're doing it company by company.

What we also have—and I would ask that this be put in the record—from Moody's Investor Service July 2005, a study in which they say large positive unexplained bonus and option awards are predictive of both default and large rating downgrades. We have the problem of incentives that have operated as perverse incentives.

I think what has been uncovered about Fannie Mae is disgraceful. But it is, unfortunately, not the only example in America of ambiguity in accounting, combined with various forms of incentives, leading to abusive practices.

So, all we are saying is this; for the great bulk of corporations, where people think everything is fine, this wouldn't be a factor. But in many, many cases we have seen abuses.

We have also seen, in my judgment, excessive incentive for people to merge and sell. When a corporation is sold to another corporation, and hundreds of thousands of people are laid off in consequence, and the seller, the CEO who sold, gets \$100 million, \$150 million, that's not the way it ought to work.

So, that's what this legislation is about. This hearing, as I said, was called at the request of the minority to deal with that, and I look forward to hearing from the witnesses.

Mr. BAKER. I thank the gentleman. By prior agreement, we were to have two statements on each side. I have no further statements on my side, so we go to Mr. Scott at this time for recognition. Mr. Scott?

Mr. SCOTT. Yes, sir. Thank you very much. And I want to commend my colleague, Congressman Barney Frank, for taking leadership on this.

Let me say at the outset that you find no greater capitalist than David Scott. I was trained at the citadel of capitalists, in the Warren School of Finance, so I am 100 percent for profit and moving of our free markets and our system.

And you know, my relationship with investing and the stock market goes back to the sixth grade. As our project, we went down, and I was in the sixth grade at Fox Meadow in Scarsdale, New York. Our project was to go down to the stock exchange and buy stock. I know the importance of it, and I know the importance of the market. It is the cornerstone of our capitalist system and our free enterprise system.

But we've got a problem here. And that problem is the—America's confidence in our markets, in our economic system, where we're going. And I submit to you that when we have consumers who are going out here, paying out the nose for gas at \$3.25 a gallon, and then they look and read about Lee Raymond, who is making an exorbitant amount of money, in his compensation packages. And when that comes out to the amount that the New York Times has said that Lee Raymond made in one day in his compensation package, \$144,873 a day, that's not profit. That's greed.



That is why we are having this hearing here today. That's why this is important. It's important to look at this from a significant balance. We're not after putting any limit on how much anybody can make. But it is important for the sanctity of the markets, for the protection of our investors and our consumers, that we give some transparency.

There is nothing wrong with presenting a way for—the legitimate owners of the business, the bosses of the business, should know how their managers of their businesses are arriving at their compensation package. And beyond that, there are earnings manipulations and unprofitable mergers and acquisitions.

There are things going on in corporate America that put tremendous pressure on CEO's to, unintentionally sometimes, just out of their own normal behavior, when you have the CEO's concerned with the profit margins and how they arrive at it, they are also concerned and determined how they get their compensation package, we have nobody else looking at it, then we find these kinds of examples like Lee Raymond and others.

We are not saying corporate America does not have anything to worry or to fear about what we're doing. But anybody with any stretch of common sense would know that what is happening in terms of the compensation packages of CEO's is alarming.

Let me just share this one very vital statistic that comes from the corporate library's recent CEO pay survey. It said that the median total compensation received by CEO's increased 30 percent in Fiscal Year 2004, with the average increasing 91 percent, driven by 27 CEO's receiving compensation over 1,000 percent greater than what they got the previous year. A 1,000 percent—10 times 100 percent increase in 1 year. That's outrageous. It goes on to say that the 2004 increase comes on top of median increases of 15 percent of the fiscal year.

Now, here is the other point, which is very dangerous, for where we're headed, because the middle class is getting squeezed in so many ways, almost out of existence. This disparity has grown significantly over the last few years. In 1991, the average large company CEO received approximately 140 times the pay of an average worker in his company. And then, just 12 years later, in 2003 that ratio jumped to 500 times as much as their average employee is making.

Mr. BAKER. Can you begin to wrap up for me, Mr.—

Mr. SCOTT. I will.

Mr. BAKER. Thank you.

Mr. SCOTT. So, I wanted to make sure everybody understood that there is great need for us to respond and come, and I think corporate America will be most appreciative of us taking a very good sobering look at this situation. It's out of balance, and we want to bring some balance and transparency to it. Thank you, Mr. Chairman.

Mr. BAKER. I thank the gentleman. It is now time to turn to our distinguished panel that we have been able to secure for today's hearing. And—

Mr. FRANK. Mr. Chairman, could I just—I appreciate what we have done, and you know, we want to have a balanced hearing. It was under the rules, the minority's right to invite.

I would note that several people couldn't come. We did invite Professor Bebchuk, but he was out of the country. We invited Lynn Turner, formerly of the SEC, and he was unable to come. We invited the U.S. Chamber of Commerce, but they declined to send anyone. We appreciate the Business Roundtable being here. And we also invited Mr. Phil Purcell, Mr. James Kilt, and Mr. Lee Raymond. And for reasons I don't understand, they weren't able to come. Maybe that's just as well, because we would not have been able to afford their hourly rate.

Mr. BAKER. I think it was a travel budget issue.

Mr. FRANK. Well, we couldn't afford the hourly rate, but people do testify here for nothing. But we did invite some people who we thought would take the—and we do have, I think, a balance here, in terms of the witnesses. Thank you.

Mr. BAKER. I thank the gentleman. At this time, I would like to—well, our customary practice is that your formal statement will be made part of the record. We request that your comments be limited to 5 minutes, to enable members to ask as many questions as possible. And we do appreciate your courtesy in participating.

Our first witness is Ms. Nell Minow, editor in chief of the Corporate Library. Please proceed as you like.

#### **STATEMENT OF NELL MINOW, EDITOR IN CHIEF, THE CORPORATE LIBRARY**

Ms. MINOW. Thank you very much, Mr. Chairman. And thank you all for your opening comments, which I think set the agenda beautifully.

I wanted to associate myself, Mr. Chairman, with your concerns about the class action abuses, and welcome any proposals that you have for making legitimate shareholders the controllers of the process, rather than the trumped up plaintiffs.

Mr. Scott, I particularly want to thank you for citing our report, the Corporate Library's report. And I have several family members who went to the Fox Meadow School, so I know you got a fine education there. And I appreciate your comments, and Mr. Frank's as well.

You know, Marie Antoinette would be embarrassed at some of these numbers, perhaps, United Health Group—\$1.6 billion with an additional \$1 million being granted to the CEO. And yet, somehow the CEO's of America are embarrassment-proof.

I agree that most people in most corporations and most boards of directors are honorable, decent people, but Warren Buffet said that even he has been embarrassed into approving excessive compensation packages. And if Warren Buffet cannot exercise control in the boardroom, then I think we do definitely have a problem.

Back in the 1950's, John Kenneth Galbraith said, "The salary of the chief executive of the large corporation is not a market award for achievement. It is frequently in the nature of a warm, personal gesture by the individual to himself."

If you look at the people in the top stratosphere of pay, it's a very, very small group at the top of the pyramid. You've got rock stars, movie stars, athletes, investment bankers, and CEO's. The other four are the ultimate pay-for-performance people. You can look in the paper every Monday and it will say, "Reese

Witherspoon's last movie made this amount over the weekend, her asking price for the next movie has gone up to \$20 million," or it can go down. You can look at John Travolta's salary over the years; it has gone up and down, very much in accord with the box office returns. The same thing goes for athletes, as well as investment bankers. They could be waiting tables in a week, if a deal fell apart.

The only exception to that rule, the only exception where pay and performance are not linked, is with CEO's. Why is that? Because CEO's pick the people who set their salary. If I wanted to pick the people who set my salary, I could put my mom and dad on the board, and believe me, my pay would go up. That is not a good system.

The problem is that we've got significant impediments to the market working here. Like, Mr. Scott, I am proud to call myself a capitalist. I went to the University of Chicago, which is just as committed to capitalism as the Wharton School, and I like to see the market working. Right now, the consumers of CEO pay are the shareholders, and they do not get a chance to send the market that all-important response.

The two key points that I want to make about CEO pay are these. The first one is that executive compensation has to be looked at like any other allocation of corporate assets. What is the return on investment for CEO pay? The answer, if you look at Rakesh Khurana's outstanding book, "In Search of a Corporate Savior," is that we are competitive perhaps with a piggy bank, in terms of the return on investment that we get from CEO pay. We must be able to subject that to that same market test that we do for any other allocation of corporate resources.

And the second point I want to make is that this truly, truly undermines the legitimacy of our capitalist system here. It is such an offense, that I think that the abuses of CEO pay are as much a reason for the offshore relocation of listed companies and IPO's as any other problem that you might name.

I would like to reserve the rest of my time to answer questions, and I appreciate very much the opportunity to be here.

[The prepared statement of Ms. Minow can be found on page 97 of the appendix.]

Mr. BAKER. Thank you for your testimony. Our next witness is Ms. Ann Yerger, executive director, Council of Institutional Investors.

Welcome.

#### **STATEMENT OF ANN YERGER, EXECUTIVE DIRECTOR, COUNCIL OF INSTITUTIONAL INVESTORS**

Ms. YERGER. Thank you very much. Good afternoon. The Council is an association of more than 300 investment organizations, including more than 130 public, corporate, and union employee benefit plans, with more than \$3 trillion in assets. Council members are the ultimate capitalists. They have a very significant and long-term stake in the U.S. capital markets. The average council fund puts about 45 percent of its portfolio in U.S. publicly-traded stocks, and about 30 percent in bonds, U.S. bonds. On average, about half of their U.S. equity portfolios are passively managed.

As long-term investors, our members have a vested interest in ensuring that U.S. companies attract, retain, and motivate the highest performing employees and executives. We, therefore, support compensating executives well for superior, long-term performance.

However, headlines in recent years have highlighted a host of executive pay abuses and excesses at U.S. companies. Most recently, press accounts have identified how executives at a small but growing list of companies have benefitted by back-dating stock option grants to take advantage of stock-price lows, to the disadvantage of shareowners.

Council members and other investors are harmed when poorly structured executive pay packages waste shareowners' money, excessively dilute their ownership interest, and create inappropriate incentives that may reward poor performance, or even damage a company's long-term performance.

Inappropriate, or ill-designed pay packages may also suggest a failure in the board room, since it is the job of the board of directors, and more specifically, the compensation committee, to ensure that executive pay programs are effective, reasonable, and rational, with respect to critical factors, such as company performance and industry considerations.

The Council has long believed that executive pay issues are best addressed: one, by requiring companies to provide full, plain English disclosure of key quantitative and qualitative elements of executive pay; two, by ensuring that corporate boards are held accountable for their executive pay decisions; three, by giving shareowners meaningful oversight of executive pay; and four, by requiring disgorgement of ill-gotten gains pocketed by executives.

In general, the Council believes that regulatory bodies are best positioned to address shortfalls or problems with these checks and balances, and we are very hopeful that the SEC's current initiatives will address the important disclosures raised by Representative Frank in H.R. 4291.

Of note, we are currently studying the issue of shareowner approval of overall executive compensation programs, to determine whether and how to best require such an approach in the United States. And as a result, the Council has no current position on this particular provision of the bill. The Council does consider such approval a best practice.

Good disclosure is the foundation of these checks and balances. The Council believes that disclosure should include qualitative and quantitative information about all elements of executive pay, including details descriptions and estimates of the value of stock-based pay, retirement benefits, and severance agreements.

The Council, therefore, is very pleased to support the SEC's proposal to improve the executive pay disclosure rules. The Council believes the proposal will result in clearer and more complete quantitative and narrative disclosures of pay.

The SEC proposal, however, falls short in some respects, including the failure to require companies to disclose key quantitative information about performance targets and thresholds, if such disclosure might be competitively harmful. The Council believes this approach provides far too large an exemption. The Council strongly

encourages the SEC to give consideration to including in the final rule the important disclosures contained in H.R. 4291.

The provisions requiring disclosure of short- and long-term performance measures used by companies in determining the pay of executives, and whether or not these measures were met during the preceding year, are essential to investors and the marketplace at large, in assessing performance-based executive pay. These disclosures are also consistent with the executive pay disclosures recommended in the Council's corporate governance policies.

The Council looks forward to working closely with the SEC, this committee, and other interested parties, to ensure that investors in the capital markets are provided with the types of disclosures and other tools necessarily to properly evaluate the performance of company compensation committees, to assess pay for performance links, and to optimize the shareholder's role in overseeing executive pay and holding directors accountable. Thank you.

[The prepared statement of Ms. Yerger can be found on page 111 of the appendix.]

Mr. BAKER. Thank you for your testimony. Our next witness is Mr. Thomas J. Lehner, director of public policy, Business Roundtable.

Welcome, sir.

#### **STATEMENT OF THOMAS J. LEHNER, DIRECTOR OF PUBLIC POLICY, BUSINESS ROUNDTABLE**

Mr. LEHNER. Thank you, Mr. Chairman, Congressman Frank, and members of the committee. Business Roundtable, as you know, is an association of chief executive officers of leading U.S. companies with over \$4.5 trillion in annual revenues, and more than 10 million employees.

Our companies comprise nearly a third of the total value of the U.S. stock market, and represent nearly a third of all corporate income taxes paid to the Federal Government. Collectively, they returned over \$110 billion in dividends to shareholders in the economy in 2005.

We have long been leaders in the area of corporate governance. We supported the Sarbanes-Oxley reforms in 2002, because we knew investor trust and confidence had to be restored to the marketplace. That same year, we also published our principles of corporate governance, and the following year we established the Institute for Corporate Ethics at the University of Virginia. And in 2003, we published, "Executive Compensation Principles and Commentary."

And in those principles on executive compensation, we called for executive compensation to be closely aligned with the long-term interest of shareholders, and to include significant performance-based criteria. Furthermore, board compensation committees should be composed of entirely independent directors, and they should require executives to build and maintain significant equity investment in the corporation.

Finally, companies should provide complete, understandable, and timely disclosure of compensation packages, and the SEC proposal, which we support, is consistent with our principles.

In the current debate on executive compensation, a key question is how do you define performance? We believe there has been too much emphasis on short-term stock gain, and not enough recognition of other performance-based criteria. It is our belief that determining these criteria and setting overall compensation should properly remain a function of the board of directors and the compensation committee, as they are in the best position to set the standards and evaluate the performance of executives.

Concerning the recent coverage of CEO compensation, there has been a great deal of misleading information promoted by critics and reported in the media. There are over 15,000 publicly traded companies here in the United States. And if one believed even a few of the stories written, you would think all CEO's make tens, if not hundreds of millions of dollars each and every year. This is simply not the case, and we believe that this type of sensationalism is damaging to the debate, our corporations, and our shareholders.

This is not the first time that the issue of CEO compensation has attracted so much attention. In the early 1980's, when stocks were underperforming, reformers sought to limit the salaries of CEO's and tie their pay to the performance of the company. Congress obliged by placing tax consequences on annual salaries above \$1 million, and CEO's were given stock options as incentives to perform.

As the market has increased dramatically in the last 15 years, so has CEO pay. Reformers got the system they wanted, but now ironically, many are critical of the results, and they claim that the CEO pay exceeds company performance.

In fact, research that we commissioned does not support this. The Mercer 350 database shows that over a 10-year period from 1995 to 2005, median total compensation for CEO's has increased 9.6 percent, while the market cap has increased 8.8 percent and total shareholder return has increased 12.7 percent.

This trend was confirmed in an article last week in the New York Times, that cited an NYU/MIT study showing a direct correlation between CEO compensation and the value of the top 500 companies between 1980 and 2003. I have attached that article to my testimony.

We have identified two flaws that contribute to the erroneous figures that inflame the debate. First, many of the statistics cited are averages, and not medians. And as we all know, these could be misleading, because the outlier skews the average for everyone.

The second involves how stock options are counted. When options are exercised, they often represent a decade or more's worth of accumulated stock. And in the current debate, they are characterized as single annual amounts of compensation.

We all agree that shareholders provide the capital and, in effect, own companies. But the key distinction is recognizing that shareholders don't run companies; shareholders invest in companies. They profit from their growth. And in exchange for not having any liability for company actions, decisionmaking is necessarily left to boards and CEO's.

The U.S. corporate model has been the envy of the world. And in our view, legislative proposals calling for shareholder approval of compensation plans is unwise, and ultimately unworkable. If we

adopted a system where a small group of activist shareholders use the process to politicize corporate decisionmaking, the consequences could very well be destabilizing.

Some activist groups who disagree with corporate positions on social security reform, health care reform, and free trade policies, just as an example, seek to super-democratize corporations to the point of having shareholders remove directors, choose CEO's, and determine company policies and levels of pay. This is a slippery slope that we think should be avoided.

If this model were applied to CEO's, then by extension, the investing public would have a hand in determining salaries for news anchors, movie stars, and athletes.

Boards are not willing to pay a CEO more than they are worth, or more than the market price will bear. The performance metrics applied are not limited to just stock price. They also include annual profits, job creation, restructuring plans, remaining competitive in the global marketplace, and subjective factors such as company and community activities, crisis response efforts, and leadership.

One telling statistic about CEO accountability comes from our own members. In 1985, the average CEO tenure was over 8 years. Today's it's four-and-a-half. Many CEO's hired today are expected to produce in a short period of time. And while they are well-paid if they succeed, they are replaced if they fail. The Washington Post, also last week, cited a Booz Allen study that showed CEO turnover in 2005 was above 15 percent, the highest level in a decade.

We cannot state what the appropriate level of CEO pay should be, nor can we answer the question how much is enough. That would require broader social debate on wealth in our society. But within the context of corporate governance, setting CEO pay is a function of the board of directors, and should remain that way.

We do not believe in encouraging an environment where companies become gridlocked while executives pander to numerous shareholder constituencies. It is important to remember that these are private corporations designed to make a profit, and public investment in them is voluntary. We should not confuse the term "public companies" with the public sector.

The key to this process is to give investors the information they need to make informed decisions to buy, hold, or sell their investments. This is the rationale behind the SEC initiative on compensation disclosures, and this is one of the reasons why we support it.

In conclusion, we are sensitive to extreme cases of CEO compensation reported in the media, and we continue to develop and promote best practices for our members to follow. Independent boards and shareholders will deal with extreme cases, and we strongly believe that the current system has worked well and should not be changed by any historical measure. Shareholders have enjoyed enormous returns by investing in the marketplace, and that is the ultimate incentive for boards and CEO's to perform well.

Thank you.

[The prepared statement of Mr. Lehner can be found on page 74 of the appendix.]

Mr. BAKER. Thank you, sir, for your testimony. And may I start with verifying what I think I heard you indicate, relative to a data set from 1995 to 2005, a study of executive compensation as cast against the market cap of the individual company, and as cast against the rate of return to shareholders?

Mr. LEHNER. Correct.

Mr. BAKER. And those numbers were a 9.6 percent increase over that period for CEO's—

Mr. LEHNER. An increase for CEO's of the 350 companies in the Mercer database, the large 350, 9.6—

Mr. BAKER. So those 350 represent Fortune 500's, basically, or—

Mr. LEHNER. Yes.

Mr. BAKER. And then the company also experienced about an 8.8 percent net increase in market cap. And the—

Mr. LEHNER. Right.

Mr. BAKER.—shareholders rate of return was 12.7 percent.

Mr. LEHNER. Over a 10-year period.

Mr. BAKER. Okay.

Mr. LEHNER. That's right.

Mr. BAKER. I think I have another one of my delightful charts which demonstrates over a sort of similar period, my concerns about this class action litigation business, and the cost of doing business.

We've really got two. We've got one that shows the domestic effect—mine is 1990 through 2004—and then the—concurrently, the comparable in the European environment, where we have our competitors, we are the column on the far right, as a percent of GDP. And France, for goodness sake, is, you know, less than half of our litigation cost. I am really concerned.

I believe one of the witnesses indicated that compensation to CEO's was becoming a factor in whether you function domestically or in a foreign market. If that is true, then I can't see how this effect is not of equal concern in the scope of business decisionmaking.

Mr. Lehner, your data, I think, goes to a median calculation. During that period, was there any time in which compensation went down, from year to year, or was it always an increase in your analysis?

Mr. LEHNER. I know that in the last year we've looked at it, it's gone down 1 percent, I think.

Mr. BAKER. So there are market factors that cause these reimbursement rates to go up and down, depending on business cycles?

Mr. LEHNER. That's correct. I mean, a lot of these things tend to be cyclical. And again, I know we all talk from a different set of facts up here, but you know, again, I want to demonstrate that we're sensitive to the issue. This is one corporate governance issue that drives all others. And—

Mr. BAKER. Do you support the current proposal of the SEC, relative to disclosure?

Mr. LEHNER. Absolutely. I mean, we have made a couple of suggestions to them about ways that we thought it could actually be improved. But as I said in my testimony, we think that the best thing to do here is to arm investors with as much information as possible. And we think that Chairman Cox, in their proposal, goes a long way toward doing that.



Mr. BAKER. Thank you. Ms. Minow, I want to engage you in a different subject, and make quite clear that my comment has no reflection on the Corporate Library's role or function.

But I believe I have read comments attributed to you, relative to firms that are now involved in corporate governance, proxy voting, consulting services, where a rating can be given to a corporation based on those elements. And let's assume you get a 2 out of 10. Then that company can turn around and hire that firm that just did the rating to consult and tell you how to get it up to an eight. And amazingly, after you pay the consulting fee, you get the eight.

And I think the quote that I read, which I very much like was, "You cannot be an umpire and a pitcher in the same game."

Ms. MINOW. Yes, sir.

Mr. BAKER. If that, in fact, is your remark, can you help me understand better how we can cure that particular market aberration?

Ms. MINOW. Yes, Mr. Chairman, that is my remark, and I do feel very strongly about that. And of course, my firm does not do any consulting with companies. And I believe that is exactly the kind of issue that is best resolved by the market. People know exactly what those ratings are worth, if they know that they can be changed as a result of consulting arrangements.

Mr. BAKER. But shouldn't there perhaps be some requirement for disclosure of that relationship?

Ms. MINOW. No question about it. And I believe that the company involved does disclose those relationships. And in fact, I know for a fact that they do.

Mr. BAKER. But the rating agency itself does not necessarily disclose that they are rating and consulting?

Ms. MINOW. Yes, they do.

Mr. BAKER. Oh, good.

Ms. MINOW. Yes, they do. And so, I believe that the market gives the appropriate weight to the rating, understanding that they do also have the consulting relationships.

And as I said, my firm does not do that, and will never do that.

Mr. BAKER. Terrific. Ms. Yerger, my time is about to expire, but you made reference to the pending SEC proposal, and you do believe that it is advisable, and you had some further comment about other additional elements that might be included.

Would it not be appropriate for the SEC to move forward with the pending matter, implement it, and see what reaction we may get in market function as a result of it, before proceeding further?

Ms. YERGER. Well, we absolutely are very supportive of the SEC proposal, and we do want it to move forward, but we think it's important that the rule that is adopted and put in place is of high quality and has the important disclosures that we think that are necessary for the investors, to understand what is going on and to do—to perform their role, in terms of overseeing executive pay.

And we think there are—by and large, we are completely supportive of the SEC proposal. But like the BRT, we think there are some elements that could be changed, tweaked, or added to improve that.

Mr. BAKER. Thank you. My time has expired. Mr. Frank?

Mr. FRANK. Let me first ask—Mr. Lehner gave an exposition of how corporations ought to work, and particularly denigrated as an effort to “super-democratize” corporate governance by, for instance, allowing the stockholders to deselect board members. I believe you gave that as one of your examples. I would be interested in Ms. Yerger and Ms. Minow’s comments on that model.

Apparently, the model—and I was surprised by it, to be honest with you—the model, you said, that shareholders are allowed to invest, but they shouldn’t get into, really, and of the decisionmaking. And I am particularly troubled about the notion that they shouldn’t have a great deal of discretion about the boards of directors. Because the alternative is, I think, the current situation, where the boards of directors are more self-selecting and picked by the CEO’s, and that’s one of the reasons why they’re not a very independent check, it seems to me, on salaries.

But I wonder, first, Ms. Minow and Ms. Yeager, what’s your view of the role of shareholders and the governance of corporations?

Ms. MINOW. Yes, I agree, Mr. Frank. Certainly nobody better than the people in this room understand what the word election means, and yet we use that term in corporate matters where the CEO picks the candidates, no one runs against them, and management counts the votes. So that’s more like an election in North Korea than it is in—

Mr. FRANK. And as I understand it, if you get any votes you win.

Ms. MINOW. That’s correct. Under State law, which of course is governing here, if you get one vote—if you vote for yourself, you win, unless someone is running against you. I would be 100 percent happy to defer all matters of compensation to the board of directors if the shareholders had some way to elect the board of directors, or even to get rid of boards of directors that did a very bad job. And right now, that is not the case. I am—

Mr. FRANK. Ms. Yerger, your view on the role—I mean, it seems to me, at Business Roundtable Mr. Lehner describes what I would think is a very passive role for shareholders. What’s your conception of the view shareholders ought to have in the—

Ms. YERGER. One of the most basic rights assigned to owners is to elect the directors. And right now, there isn’t a meaningful election.

Mr. FRANK. It’s not.

Ms. YERGER. And we believe the majority voting for directors is one of the most single most important reform, in terms of—

Mr. FRANK. Well, let me ask you, in the absence of any significant shareholder—what is the major influence in the selection of directors? Who—as a practical matter, since the shareholders don’t pick the directors, where do the directors come from?

Ms. YERGER. They come from the board. It’s the nominating committee and the board that works on that.

Mr. FRANK. They nominate themselves.

Ms. YERGER. Essentially—

Mr. FRANK. And what about the role of CEO’s in the selection of directors?

Ms. YERGER. Well, we hope that the CEO is not involved at all. Unfortunately—

Mr. FRANK. Well—

Ms. YERGER.—in some cases—

Mr. FRANK. I hope I could lose 10 pounds in the next week, but I'm not buying any new clothes. I mean, I know what you hope. But what's the reality, in your view?

Ms. YERGER. I think that, at some companies, it is a CEO-dominated process, and—

Mr. FRANK. And in the CEO-dominated process of picking the board of directors, who sets the CEO's compensation?

Ms. YERGER. The individuals the CEO has put on the board.

Mr. FRANK. Yes, I think that's the significant problem we have. So I—and I know people say, "Well, if they don't like it, they can sell," and the problem is that it does not seem to me that's an appropriate choice for people to make. You can be locked in, etc. Mr. Lehner, one other question.

Mr. LEHNER. Sure.

Mr. FRANK. And that is I cited this Moody's survey about the incentives. And one of the things that we have in our proposal, I don't think, is fully involved in the SEC, even before you get to that super-democratization notion that the shareholders ought to be able to vote on the company, radical as that may be.

But the issue is where incentives are given if certain targets are hit, and then the targets, it turned out, were only very temporarily hit. And I can see—I've said before, accounting for derivatives seems to me to range somewhere between alchemy and astrology in the degree of intellectual vigor that you can bring to it at this point.

But—and one of the things that we have said is where targets were hit, and it turns out that was a very temporary hit, we want to know what the corporation does to get it back—not that they have to do that, but we want to know the plan. But I have to ask the broader question, and that is this whole role of incentives.

I am getting paid \$7 million to run a corporation. Why do I need to have incentives to do my job? I don't know, maybe you get an incentive at the Roundtable. I don't get an incentive. Most people don't get incentives. You're hired to do a job, you're an honest person, you're conscientious, so you do your job. Why do the most highly paid people in America, who get very large salaries and have very nice working conditions then need to be given bonuses to do what they should have been doing in the first place?

Mr. LEHNER. Sure. Let me make two quick points. One is on the question you raised a minute ago on board elections. A number of our companies have voluntarily moved to a system of majority voting for directors.

Mr. FRANK. Do you think that they should all do that?

Mr. LEHNER. We have encouraged companies to do that, but to make that determination on their own. And another—

Mr. FRANK. Well, if it is a good thing, why does it have to be done on their own? If it's a good thing to do, why shouldn't there be some encouragement to do it?

Mr. LEHNER. We do not feel that it is necessary to have—

Mr. FRANK. But what if it was? I understand that, but that is not my—

Mr. LEHNER. Blanket change in State law and a one-size-fits-all approach for everyone.

Mr. FRANK. I don't—there are 50 States, you're not going to have 1 State—but if you think it's a good idea, why shouldn't we try and have people do it?

Mr. LEHNER. We have encouraged our companies to think it's appropriate to go ahead and do so. It—

Mr. FRANK. But if it turns out 5 years from now that many of them haven't done it, do you think we should do something, or would you want to keep encouraging them?

Mr. LEHNER. I would keep encouraging them to make that determination on their—

Mr. FRANK. All right, hope springs eternal.

Mr. LEHNER. That's right.

Mr. FRANK. Heck of a policy. Go ahead.

Mr. LEHNER. With respect to incentives, you know, I think we are in agreement on this point. As I mentioned in my testimony, we think there has been too much emphasis on what we call short-termism, too much emphasis on short-term manipulation of stock gain. It's not just about the stock price in order to evaluate—

Mr. FRANK. I mean, what can we do about that? Is there a remedy, other than hope?

Mr. LEHNER. I think the important thing is that, you know, we all work to make sure that boards continue to do their job—

Mr. FRANK. I don't—

Mr. LEHNER.—and we've certainly seen, in our own surveys that we do every year, a dramatic increase in activity in board—

Mr. FRANK. I appreciate that, but I have to say that, based on experience, I think the road to excess is paved with good intentions. Thank you, Mr. Chairman.

Mr. LEHNER. We will agree to disagree on that one.

Mr. BAKER. The gentleman's time is expired. Mr. Hensarling?

Mr. HENSARLING. Thank you, Mr. Chairman. It certainly is a worthy topic that we undertake today. I certainly don't know what the optimal level of executive compensation ought to be. But I am very fearful, from hearing some of the comments of my colleagues, that we may be going down a path where the cure may be worse than the ill.

Whatever ills there may be in the corporate board rooms, I am certainly not sure that I want the executive compensation committee to consist of 435 members of the House and 100 members of the Senate.

Ms. Yerger, I used to—I spent a small bit of time in the investment world prior to coming to Congress. And I recall that any time you had somebody representing CalPERS on the other end of the line, you paid very careful attention to what they have to say.

It seems to me that institutional investors still have the opportunity to vote with their feet. And as I review your testimony, I certainly agree with the general thrust and philosophy that greater disclosure is certainly important. But explain to me the hurdles that prevent the other lead institutional investors from having a greater say-so in the marketplace, and saying, "If this is the way you're going to compensate your executives, we're getting out, we're bailing out, we're not going to own 10 percent of your company, and we're going to go invest somewhere else."

Ms. YERGER. The Wall Street Walk really doesn't work for Council members. I mean, just by virtue of their incredible size, and the fact that they have such a significant strategy of passive investing—and that's broad passive, so I'm not talking about the S&P 500, but this would be Russell 3,000-plus companies—they really simply can't just pick up and leave, which is why paying attention to corporate governance is so important. And that is why we believe full, clear, plain-English disclosure of these issues is so necessary.

Mr. HENSARLING. And speaking of producing results—and I think Chairman Baker alluded to this—on page 4 of your testimony, looking in 10 years—I believe trailing median total compensation for CEO's has increased 9.6 percent, total shareholder return has increased 12.7 percent. For anybody who doesn't know that, could you tell us the components of total shareholder return?

Mr. LEHNER. Thank you. Yes. And Fred Cook, who is going to be on the next panel, is going to talk about this more, but you know, total shareholder return represents—certainly, as I understand it—the compounded amount of annual return that shareholders get over that period, when they have invested in the stock markets. You put your money in the bank, and you get, you know, 2-, 3-, 4 percent.

But if you invested it in the market over that period, you would have a compounded return of 12.7 percent. Not a lot, if you invested \$500, but if you invested a couple of hundred thousand, it might be a fairly significant amount of money. It's all proportional. But the point is that the rate of return tracks with the increases in the market cap, and the increases in what we have looked at as median CEO pay.

Mr. HENSARLING. During—I guess you would call it—part one of this hearing, which I believe took place last week, we heard testimony from the chairman of the New York Stock Exchange.

And if I could quote from his testimony, "The United States is losing listings"—alluding to the New York Stock Exchange—"because of the persistent concern surrounding the U.S. trial bar and the litigious environment in the United States. We need to recognize that the United States today has a reputation both at home and globally as an increasingly difficult place to do business. The possibility of being sued for huge sums or also bearing the high cost of legal defense has brought many companies to a moment of reckoning that mitigates against registering their securities in the United States." Do you agree or disagree with that sentiment?

Mr. LEHNER. Generally, I agree. I have seen studies that have been done. I mean, there are a number of listing entities around the world now, and it's a competitive marketplace.

And you have people in the London Exchange and in the Asian exchanges, and they are going to companies and they are saying, you know, "Come and list with us," the litigation risk is smaller, the amount of regulation is less, it's more attractive to be in these emerging markets, and it is no question that it's a competitive environment.

Mr. HENSARLING. I see my time has expired. Thank you.

Mr. BAKER. The gentleman's time has expired. Mr. Sanders?

Mr. SANDERS. Thank you, Mr. Chairman. Let me begin by applauding Ranking Member Frank for bringing forth this hearing, which touches an issue that I think gets nowhere near the kind of discussion it should be getting in Congress, or in the media, or in the United States of America in general.

And while today we are looking at legislation dealing with the relationship between stockholders and CEO's and boards of directors, the truth of the matter is that this issue touches on a broader issue, and that is the growing gap between the rich and the poor in America, and the fact that many would argue that we are now moving toward an oligarchy in which fewer and fewer people have more and more wealth and more and more power, while people in the middle, working people, see their standard of living decline, while poverty in America decreases.

Just in the last 5 years alone, we have seen 5 million more Americans slip into poverty. We have seen the wages of millions of American workers decline. Many people work longer hours for lower wages. And yet, the people on top have never had it so good.

So, in a sense, what we are talking about today is not just CEO compensation, not just stockholder rights, but what kind of Nation we are becoming.

And the fact of the matter is that today, the wealthiest 1 percent own more wealth than the bottom 90 percent. The richest 1/100th of 1 percent, 13,000 families, earn more income than do the bottom 20 million American families. And I think when ordinary people in rural States like my own, working people have to travel 50 or 100 miles to work and are now paying \$3 for a gallon of gas, read in the paper that former CEO's of companies like Exxon Mobil are now—Mr. Raymond—are now receiving \$398 million in a retirement package, they are wondering about what goes on in the United States of America.

Now, we hear a lot—and sometimes political campaigns are run on moral values. And when we talk about moral values, often it is associated with issues like abortion or gay rights, and so forth and so on. I want to ask Mr. Lehner a question about moral values.

Mr. Lehner, do you think it is morally appropriate that CEO's in America today, for large corporations, now earn over 400 times what their employees make? Do their needs—do they eat 400 times more? Do their kids need 400 times more education? Do they need 400 times more housing? What is your sense about what it means to America, in terms of our moral values, that so few have so much, and so many have so little, and that the gap seems to be growing wider?

Mr. LEHNER. Well, I think you raise a good point, and you know, I should point out that our CEO's definitely recognize that they have a much greater social and economic responsibility than those that came before them.

I might point out that our companies give more than \$7 billion a year in charitable contributions, and that represents nearly 60 percent of total corporate giving.

Mr. SANDERS. Mr. Lehner, if I may, one of the reasons that people give more in charity is that we have more and more people in our country who are losing health insurance. Poverty is increasing, directly as a result of many policies made in this Congress by

Members of Congress who receive huge campaign contributions from people in the Business Roundtable.

So, when the Business Roundtable encourages companies to throw American workers out on the street, move to China, and poverty increases, then you come in and say, "Gee, we increase money for charitable organizations," some of us are not deeply touched by that.

Mr. LEHNER. Well, my response to that is quite simply that I think there is a recognition that there are some who have less than others in this society, and I think our members have been very responsive—

Mr. SANDERS. What is the moral? I asked you a simple question. I understand that some of your CEO's and companies give money to charity, and I appreciate that. Morally, in your judgment, is it appropriate, is it a good thing that 13,000 families earn as much income in America as do the bottom 20 million families? Is it a morally good thing?

Mr. LEHNER. No.

Mr. SANDERS. Okay, thank you. What would you suggest that we do about that?

Mr. LEHNER. I would suggest that we all work together to, you know, lift the tide so all boats can rise.

Mr. SANDERS. Okay.

Mr. HENSARLING. Will the gentleman yield?

Mr. SANDERS. I would love to, but I just don't have a whole lot of time. If you will excuse me, let me ask the other people up there. Yes?

Ms. MINOW. Thank you. This is exactly what I was referring to when I said that this is undermining the entire system of capitalism. It takes away the credibility of our system if it is allowed to have such an outrageous, such an appalling, such an atrocious result. And we are risking losing a system which has created a lot of jobs, which has created a lot of goods, and which has created a lot of services and a very robust system.

I worry very much about the beneficiaries of those pension funds who are members of the Council, institutional investors. Those are the working people whose retirement assets are at risk because of this atrocious behavior.

Mr. SANDERS. Ms. Yerger, would you comment on the moral implications?

Ms. YERGER. Well, I can comment from a personal standpoint—the growing gulf between what the top paid executives are receiving and what average workers are—is astonishing and deeply troubling. And it's ironic for us that, at a time when many companies are freezing or eliminating their retirement programs—

Mr. SANDERS. Right.

Ms. YERGER.—at the same time, frankly, that they are paying their executives so much, and indeed, providing them with quite lucrative retirements—

Mr. SANDERS. I mean, one of the points that I think Mr. Frank made earlier is that what you're seeing is that CEO's salaries soar in particular companies, these very same companies that are having growing obligations in terms of the pensions of their workers.

And we know of instances where CEO's have been compensated in an incredible way, while at the same time they're cutting back on the pensions of their workers. I would yield to—I don't know how much time I have—

Mr. BAKER. You are over by about a minute already.

Mr. SANDERS. Okay, then. I am sorry.

Mr. BAKER. But I thank you for yielding, anyway. I will just go ahead and proceed to the next member, if I may. Let's see, Mr. Price?

Mr. PRICE. Thank you, Mr. Chairman, and I want to commend you for addressing the important areas of cost of business in this total discussion. And I appreciate you bringing light to the class action suits and the cost of litigation, because I think it is a significant cost driver.

Mr. BAKER. Would the gentleman yield on that point? I just want to correct my record, if I may.

Mr. PRICE. You want to stop my clock?

Mr. BAKER. Yes. I have been accused of doing that a lot.

The figure that I used earlier, as to the settlement in the Florida tobacco litigation per attorney, I cited a figure of \$233 million. The staff advised me that I was incorrect. It's actually \$283 million, with the typical award to the injured party averaging a little over \$300,000, just for the record. I thank the gentleman.

Ms. WASSERMAN-SCHULTZ. Would the gentleman yield?

Mr. PRICE. Not at this point, thank you. I think that hearings on those specific issues would be very, very helpful.

You know, I have oftentimes said that you can't pay for this kind of entertainment. And I don't mind being entertained. But I find it peculiar that we have begun a mocking and denigration of a system that has provided more prosperity and greater opportunity than more individuals ever on the face of the earth.

I think that we need to be commending and attempting to assist in our system of capitalism, and not attempt to move down a road that I think would be the destruction of our form of not just commerce in society, but our form of government.

We all believe that disclosure is important, without a doubt. And we look forward to assisting the SEC in coming up with appropriate rules and regulations.

Ms. Minow and Yerger, I would appreciate your comments on the statement by Mr. Lehner that the total median compensation for CEO's over the past 10 years has increased by 9.6 percent, and that total shareholder return has increased by 12.7 percent over that same period of time, and market cap for the business has increased by 8.8 percent. Do you—are those numbers with which you agree, or disagree?

Ms. MINOW. I do not—we do not agree with those numbers. We have submitted our own report, which was cited by Mr. Scott earlier, showing that CEO pay in 2004 was up 30 percent, up this year, again; 11 percent just in the last 2 years.

Mr. PRICE. Do you use average or median?

Ms. MINOW. We use average.

Mr. PRICE. So you would agree that in using average, it can skew the number that you reach.



Ms. MINOW. Yes. However, so can using median. And with regard to the specific figures that you are citing, let me say that you have sort of an “X” equals “X” result, because since a large part of that pay was tied to total shareholder returns, of course it’s going to rise with the total shareholder returns of the market as a whole.

The problem with the current system of stock options is that 70 percent of those option gains are attributable to the overall market, and that’s why we have these anomalous results.

I am thrilled when Bill Gates makes money. I am thrilled when people earn a lot of money and get a lot of money. I am a capitalist. It’s when the performance and pay are not linked that there is a problem. And that is the problem with the stock option payment, is that they just give millions and millions and millions of stock options, so that when the stock goes up a dollar, if you have 2 million options, you’ve made \$2 million, whether the overall market or your company—

Mr. PRICE. Incentives have been put on the table here as being something that is apparently bad, I guess. Do you think that companies ought to be able to offer incentives for their CEO’s for—

Ms. MINOW. Of course. Listen, I run a business, and I hope my sales guy is the highest paid guy in my business, because that benefits me as a shareholder, and as an owner of the business.

Mr. PRICE. Ms. Yerger—

Ms. MINOW. So, yes, I believe in incentives.

Mr. PRICE. Ms. Yerger, do you want to comment on incentives, and then very briefly on whether or not you agree or disagree with the numbers that Mr. Lehner put on the table?

Ms. YERGER. Well, first, we are very supportive of incentives, but we want executives to be incentivized for long-term sustainable performance. So it’s really about how those arrangements and programs are structured.

Mr. PRICE. Would you agree that the average lifetime for a CEO in a major Fortune 500 company today, Ms. Yerger, is four-and-a-half years? Is that correct?

Ms. YERGER. I don’t know the number, per se, but I do know it’s shortened.

Mr. PRICE. And how do you determine long-term performance in a four-and-a-half year period of time?

Ms. YERGER. We think it has to do with the business cycle, and product cycle. We think 5 years is probably about right, 3 for some companies.

Mr. PRICE. So you reward them after they’re gone?

Ms. YERGER. No, you’re rewarding them while they’re there.

Mr. PRICE. Where would—Ms. Minow and Ms. Yerger, where would you put the cost of executive compensation on the list of items that—in terms of the cost of doing business for a given company? Where does it fit?

Ms. YERGER. I guess, if I could—

Mr. PRICE. Go ahead.

Ms. YERGER.—I would like to comment that, I mean, our testimony has nothing to do with numbers. The Council doesn’t have a set magic number that we think executives should be paid. We really are about making certain that executives are appropriately

paid for their performance, and we want to address those issues where there are abuses and problems with the system.

Mr. PRICE. Would you—

Ms. YERGER. So I kind of don't want to get hung up on numbers here.

Mr. PRICE. Would you agree that areas like taxation and litigation and regulation are significant cost drivers for business, and may, in fact, result in more difficult performance for businesses than something like executive compensation?

Ms. YERGER. I would think it probably is a line item issue. Executive pay is a very small number.

We do think, though, that executive pay has corporate governance ramifications, it has a singling effect. I think it does drive performance and motivate certain behaviors. And that's why we think it's so important, from a corporate governance standpoint.

Mr. PRICE. Ms. Minow, my time has expired, but I would love to hear your comments.

Ms. MINOW. Thank you. I think that, as I said, like any other asset allocation in the corporation, it has to have a competitive return on investment. And currently, under the current system, the return on investment for CEO pay is significantly less than other kinds of corporate allocation.

Mr. PRICE. Where would you put executive compensation in the list of items as it relates to taxation or litigation or regulation, in terms of importance of cost drivers for business?

Ms. MINOW. In terms of cost drivers? I would say it's a very significant one, because I do believe in incentives, and I believe that if the incentives are poorly aligned in the pay package—one reason for this excessive turnover in CEO's is because the downside protection is so significant—then I think because it is a cost driver, it's very significant, certainly in the top 10.

Mr. BAKER. The gentleman's time has expired.

Mr. PRICE. Thank you.

Mr. BAKER. I thank the gentleman. Mr. Kanjorski?

Mr. KANJORSKI. Thank you, Mr. Chairman. I tried to—or I fear to tread in this area, to tell you the truth, although I heard some remarks by my colleagues on the other side, and some of the responses, that I guess I have to get into.

I didn't know that the Constitution said that we have a capitalist system. I understood that we have a Republic, and that the economic system we practice can be any type and still be the United States of America. I just wanted to make sure the record reflects that, to my knowledge, nothing in the Constitution guarantees a capitalist system.

And going to capitalism, my observation is that we have failed to understand remuneration for capitalism, which really represents new, inventive ideas. And the reward of those ideas, ultimately, may grow into a great company. The Thomas Edisons of the world, the Henry Fords of the world, and the Bill Gates of the world have been very well-compensated for their novel contributions to the capitalist system that exists in America.

One of the things that disturbed me, though, with the attention being paid to—and not being paid to—executive salaries is that

how many great inventors and discoverers in our corporate world receive nothing for their great invention?

And I remember reading, to my astonishment, that the inventor of aspirin—which is probably one of the most-used medications in our society, and creates tremendous profit for the multiplicity of corporations—the initial inventor of that never received one dollar of benefit for his great invention. It became the property of the corporation. And everyone has his right to, I guess, surrender by contract their right to reward, but that would be a contradiction to the idea of rewarding the inventor, or the creator of wealth and new ideas.

What bothers me in this structure is, one, that we even have to inquire into it. It shows something has gone awry here. And two, you know, how much money do some people really need?

I was reading the Exxon Mobil retirement pension, \$400 million, and I like to play with mathematics, so I calculated that, at 6 percent return—that's roughly \$24 million a year—so that that poor executive would only have \$100,000 a day to live on. That's such a piddling amount, really, that we ought to get together here in the committee and come up with additional funds so that he can enjoy life in excess of \$100,000 a day.

Now, there is nothing immoral about that, I guess, to some people, but I just wonder, your experiences, how about our sister economies in the world, in the industrialized world? What is the proportion of executive salaries in England? In Japan? In Germany? To my best recollection in reading, we exceed them by such gigantic proportions, that it's almost embarrassing. Is that correct?

Ms. MINOW. It's hard to say, because they are not subject to the same disclosure rules that we are. There is a lot of hidden compensation. So that, for example, in Japan the salary is quite modest that is disclosed, but there are some undisclosed bonuses and benefits that ratchet things up quite a bit.

There is also the case of Daimler Chrysler. Daimler merged with Chrysler and then replaced all of the American executives but kept the same pay scales but did not adhere to the disclosure rules. So it's difficult to say.

But I think it is fair to say that in the United States the pay packages are much, much higher than anywhere else.

Mr. KANJORSKI. Is this perhaps a failure of the functioning process system of corporate life, that the control in corporate life is so vested in a limited number of executives that can influence the action, actually, of the compensation committee or the board, and because in very many instances they select the board nominees?

Ms. MINOW. I think that's the answer. I think because the CEO picks the board, and sets the pay of the board, and determines the tenure of the board, we shouldn't be surprised that the board rewards the CEO.

In fact, at the Corporate Library, we have found that the single most significant indicator of excessive CEO compensation is how many other CEO's are on the compensation committee.

Mr. KANJORSKI. So, sort of you rub my back and I will rub your back, is that—

Ms. MINOW. Exactly. And then there is almost virus compensation, where you can trace a bad excessive compensation plan, going

from one company to another, as the director brings it back to his own company.

Mr. KANJORSKI. What would be a reasonable solution that the Congress doesn't get involved in setting salaries, but we—I think that would be wrong.

Ms. MINOW. I think the last time Congress got involved—forgive me—it was a mistake. I think by setting the cap, and dealing with it through the tax code, that was a mistake that had terrible unanticipated consequences. I think the most useful thing that Congress can do is the proposal that Mr. Frank has already addressed, giving shareholders the opportunity to vote no.

Shareholders like the company, they've bought into the company, they want the company to succeed, and they want the CEO to succeed. But there has to be some kind of a stop-gap. And I don't worry about extremists, because by definition, extremists are not the majority. If 60 percent of the shareholders think that the CEO is overpaid, then I think it's fair to say he's probably overpaid.

Mr. KANJORSKI. So, transparency, is that—

Ms. MINOW. Transparency, but you know, you can provide all the information, and that's great, but you have to give the people who are getting the information the opportunity to act on it, otherwise it's not going to do any—

Mr. KANJORSKI. Don't you think investors may be greedy too, if their returns are extraordinary, and they don't really care?

Ms. MINOW. That's fine. Investors should be greedy, because as long as we're going to stick with the system of capitalism, that's part of what drives it.

Mr. BAKER. The gentleman's time is expired.

Mr. KANJORSKI. Thank you, Mr. Chairman.

Mr. BAKER. I thank the gentleman. Mr. McHenry?

Mr. MCHENRY. Thank you, Mr. Chairman. I certainly appreciate the ranking Democrat insisting on this meeting. It has been a wonderful display of socialism versus capitalism, and I am proud to say I embrace capitalism.

I didn't realize it was a revolutionary concept, until I started hearing members from the other side of the aisle talk about this, that this is a choice for America, that maybe we should be a socialistic republic. It's just amazing to me. It's absolutely amazing.

A colleague who has unfortunately departed talked about contributions, that somehow corporate contributions or executive contributions have an influence on public policy. I would dare say that his side of the House should look at compensation that they receive, their contributions that they receive from the trial bar. I would say that's a far larger driver, in terms of shareholder health and the value that shareholders get and investors get from corporations, when you look at the pay-out to trial lawyers.

If we can bring up chart number four, you can see, in real dollars, what is happening in the marketplace. Compensation to trial lawyers, \$40 billion. Now, how many years is that? That is one year. Compensation to the Forbes 500 CEO's, all of them put together, everything—stock options, performance bonuses—how much? \$5 billion.

Trial lawyers are the ones who are sopping up investor health in this country, and driving companies to delist in this marketplace and go to other places around the world.

I would love to hear your comments, Mr. Lehner, in terms of—

Mr. LEHNER. You have no argument from me on that point.

Mr. MCHENRY. That's a good answer. I suspect you don't believe in socialism, you believe in capitalism, maybe. Ms. Yerger? You look interested.

Mr. KANJORSKI. Will the gentleman yield for a moment, since you're going to make a comparison?

Mr. MCHENRY. If I may finish with my questioning, I will do that at the end, Mr. Kanjorski.

Ms. YERGER. First, there may be agreement on one thing, and that is that probably all lawyers are overpaid. I will comment that from Council members' perspectives, who again, are long-term owners, they are owners of these companies before an alleged problem, during an alleged problem, and after an alleged problem, securities litigation is sort of the last step for them. I mean, that's a draconian measure at the most problematic companies. And we think it does play a role.

There has been plenty of evidence that when institutional investors are the lead plaintiffs in these cases, and are doing their jobs, overseeing the case progress and negotiating the contracts with the plaintiffs' firms, the fees go down. And we think it's very important that the process be set up, as Nell said earlier, that these cases not be plaintiff driven, but are—or excuse me, lawyer-driven, but indeed be driven by meaningful plaintiffs.

Mr. MCHENRY. So you would like to see some reform of that process?

Ms. YERGER. I think it's worthy of a review, yes.

Mr. MCHENRY. Well, that would be wonderful to come back and discuss the chairman's bill, the legislation that we're proposing.

Incidentally, Milberg Weiss today—I think it would be a little overplay about the Enron guys going to jail, which certainly is a market-driven force, that their company went bust, and they went bust, and now they're going bye-bye, it shows that our laws work in this country, and bad people go to jail for bad performance and bad things that they did—but Milberg Weiss, big plaintiffs law firm, specializes in securities class action suits, again, a driving force in security litigation, the law firm, you know, they've been indicted, and some of their top lawyers—incidentally, large donors to the other side of the aisle—you know, they got caught giving \$11 million in kick-backs for those in the class of shareholders that were part of the process.

Now, that is certainly egregious, and they have been involved in 150 lawsuits. Certainly I would say that factor there should be what we should—should be our discussion today, not about executive compensation. Because as a shareholder, as I am in certain companies that I disclose, I have the ability to use the marketplace and walk. And I would say that the marketplace does have some strength in this. Would you agree, Ms. Minow?

Ms. MINOW. I think the marketplace—there are significant impediments to market forces, with regard to CEO pay. I share a lot of your concerns about the litigation, but I think with regard to the

earlier chart that we saw with the spike in settlement amounts, you would have to recognize that we also had a spike in scandals, and I think that there is a correlation there.

Mr. MCHENRY. There is a correlation? But you mentioned before that rating agencies—

Ms. MINOW. Yes.

Mr. MCHENRY.—that market forces work—

Ms. MINOW. Yes.

Mr. MCHENRY.—there.

Ms. MINOW. I am a capitalist. I—

Mr. MCHENRY. So you're saying that market forces don't work in terms of shareholders moving their capital out of that company because they don't see it being governed correctly?

Ms. MINOW. Correct. We have talked about that earlier. Most of the large shareholders are essentially permanent investors. And when there is a pervasive problem, there is really no—the transaction costs are prohibitive. There is really nowhere for them to go.

So, for me, the market impediment here is the inability of shareholders to provide any feedback, any oversight, with regard to this disclosure information, which is very valuable.

Mr. MCHENRY. Mr. Chairman, I would love for you to call a hearing and discuss the impact of trial lawyers and the impact that they are having on investors today. And that huge, enormous cost to every investor across this country of out-of-control lawsuits, especially with these securities litigations, and especially with this firm that has been indicted. I would certainly appreciate it, and I would certainly appreciate your leadership on creating legislation that will address this enormous problem.

Mr. BAKER. I thank the gentleman—

Mr. FRANK. Would the gentleman yield for 10 seconds?

Mr. MCHENRY. I am out of time.

Mr. FRANK. If I could get 10 seconds, I just want to say we rarely have control over the hearings, but if the majority wanted to call that hearing, we would be glad to come. But I should make a note. The majority controls the hearings, we have very little to say about it.

Mr. MCHENRY. You would support that, Mr. Frank?

Mr. FRANK. I just said I would. Maybe I talk too fast.

Mr. MCHENRY. I'm from the South. We process a little slower.

Ms. MINOW. And I would be delighted to come back and testify on that point, because it's a matter of great concern to me. I have written about it a good deal.

Mr. BAKER. Thank you very much. The gentleman's time is long expired.

Mr. KANJORSKI. Mr. Chairman?

Mr. BAKER. I'm sorry?

Mr. KANJORSKI. May I have—I requested 30 minutes, and it wasn't available. I just wanted to correct, on the record—

Mr. BAKER. Seconds?

Mr. KANJORSKI. Yes, 30 seconds.

Mr. BAKER. Thank you.

Mr. KANJORSKI. The statistics offered by Mr. McHenry showed the Fortune 500 CEO's receiving \$5 billion, and then he said, I think, the fees of the trial bar at \$40 billion. And I have no reason

to dispute those two figures, except I would like to say that there are probably 500,000 trial lawyers and only 500 CEO's.

And I think the first statistics should be let's take the top 500 litigators, or trial lawyers, and compare them to the salaries of the top 500 CEO's, and that would be more comparing apples to apples.

Mr. MCHENRY. Mr. Chairman, I would say that, to address this, to be fair and simple about it, one law firm, one securities law firm, netted almost \$2 billion over the course of 10 years by targeting investor classes. And so, let's put that up there, compared to CEO compensation. The trial lawyers are raking it in—

Mr. BAKER. If I can suggest, we need to get back to regular order, because we're going to be killing each other here in a minute. Mr. Watt?

Mr. WATT. This is so bizarre, that I'm not even going to get in it.

[Laughter]

Mr. WATT. But I appreciate the offer. I thought we were having a hearing about executive compensation, but obviously my friend from North Carolina thinks that this is more about politics and beating up on trial lawyers. So, you know, that's bizarre. Maybe it helps his entry into the leadership, or whatever he thinks his ratings are publicly, but I think it's embarrassing to this committee. I yield back.

Mr. BAKER. I thank the gentleman for yielding back. Mr. Paul?

Mr. PAUL. Thank you, Mr. Chairman. I find the hearing and debate very interesting. I would like to start off by saying that recently Mises and Hayek was used to defend the position that protective tariffs on sugar was not a good idea, and I would like to suggest also that if you further read Mises and Hayek, they would argue the case that it is no business of the politician to deal with something as subjective as compensation.

Excessive compensation is a purely arbitrary concept. There is no way that you can come up with an objective figure to measure anybody's compensation, except maybe the U.S. Congress, and if you took—went to the American people, they would probably endorse the idea that there is excessive compensation of Representatives.

This whole idea that they don't deserve their pay, or a false incentive, what about the pay of a guy throwing a baseball, whether it's 90 miles an hour or 100? He has a tremendous incentive to work. And he makes \$10,000 a pitch. I mean, who gets hysterical about that? What about somebody who gets on a stage and is on a stage for 30 minutes and makes \$20 million? That sounds excessive and abusive and obscene to me, but no, we don't attack that.

So, I find this is misplaced. There are a lot of people in this Congress making sure government doesn't make a moral judgment on our personal behavior, our lifestyles and our habits, our drinking habits. And as far as I'm concerned, it is none of the government's business. But as soon as there are personal choices and personal decisions made regarding personal compensations, excluding trial lawyers and excluding movie stars and baseball players, they are fair game, because they are evil and monstrous, and we have to limit it, and we can't have the moral authority to defend the right of freedom.

What about a Bill Gates? I mean, how much more money could he make? And who cares? I mean, if he has \$10 billion or \$100 billion, he deserves it because he produces a product and he produces jobs.

Now, there are some things that I would concede about this. I think there is abuse. Matter of fact, I agree with the comments from the gentleman from Vermont about the gap between the rich and the poor. But the market isn't the reason these problems exist. This is a natural consequence of what happens when a country destroys their money. You wipe out the middle class, and you create excesses in certain areas.

What happened when we had the NASDAQ bubble? Were there excessive salaries? It wasn't lack of regulation. We had this abuse because there was so much money flowing in there, and so much speculation, and the people were swallowed up into it, and people made millions and millions, and a lot of little people lost their money.

But it's a monetary phenomenon. It is not a lack of freedom phenomenon. And what we're doing here in this attack on freedom of choice and making a decision is because the market decided that somebody could make so much money, and if we could only limit the compensation, we're going to solve our problem. I will tell you, I think we're completely off the track.

And I put in my vote for the market economy and for freedom and personal choices, and a sound economy where you don't have this distribution of wealth that comes about where the rich and the poor have a huge gap. And it's going to get a lot worse. And I will tell you what. When you come in with more regulations and decide about who is going to serve on boards and over-regulate corporations, let me tell you, things are going to get much, much worse, because you're dealing with symptoms, and you're not dealing with the cause.

We need a stronger defense from the business community to defend liberty, to defend capitalism. It's a moral defense. It's a moral defense of freedom—with the restriction no fraud. But the greatest fraud is what we're doing with our monetary system, and that is created by us, here in the government. And that's what we have to deal with.

And I yield to the panel, if you have any comments about this statement.

Ms. MINOW. I would like to speak. I associate myself with almost everything you said. I completely agree, it is not up to Congress to decide what somebody should get paid, and I have already spoken about my enthusiasm for Bill Gates's salary and also for the very, very market-driven system of setting salaries for athletes and performers.

The problem is, as long as we're allowing CEO's to pick the people who set their pay, we have these anomalous results where the pay and performance are not linked, and that's what we're trying to address here, by putting that power—removing the market impediment to having the people who provide the capital having some say, either in the selection of directors or in capping excessive pay. So let's put that right back into the market. That's what I support.

Mr. PAUL. Any other comments?



Ms. YERGER. I would just second what Nell says. Our—from the Council's perspective, the most important thing is to make certain that there is full transparency of these arrangements, so that the market can understand them and assess them.

Mr. LEHNER. I, too, would associate myself with a lot of your comments. As a general rule, I don't think it's a fair statement that every member of these boards just go ahead and rubber stamp what the CEO's want, or that the CEO's necessarily reach out and hand-pick all of their directors.

I think boards have gotten much more vigilant the last few years. There are associations of boards that you can reach out and talk to. They have reams of information on nominating committees and boards, and I would encourage you to look at that, as well.

Mr. PAUL. Let me just take 1 second. I would say the market worked rather well, in spite of the fact that I believe the government created the financial bubbles, the market did eliminate the bubble, and those salaries came down. So there are market forces that can accomplish, I think, what we're all anxious to see. And I yield back.

Mr. BAKER. I thank the gentleman for yielding back. I would just point out for the record, since we have touched on athletics, the Yankees are paying A-Rod \$25 million to bat 270. I think we ought to get that in the next—

[Laughter]

Mr. BAKER. Mr. Miller?

Ms. MINOW. Let's have a hearing on that.

Mr. FRANK. Will the gentleman yield?

Mr. MILLER. I yield 10 seconds to Mr. Frank.

Mr. FRANK. Well, first, as to athletes—and let me just say, since it came up—if we went to a la carte cable pricing, and people didn't have to buy—because what's supporting athletes' salaries is the poor cable person. I would be willing to make that a la carte, and that's where that comes from.

Beyond that, though, I would just say to my friend from Texas, since he was obviously alluding to—I think I'm the only one who quoted an Austrian economist, so he probably meant me—I agree, it is none of our business to set things, to set salaries. All we are talking about is, first of all, it's the SEC, under our former Republican colleague, that is intervening to require corporations to give out more information. I think they are doing it correctly, as does the Business Roundtable, essentially.

Beyond that, all we are saying here in this bill is let the stockholders do it. So I don't think anybody is advocating having Congress set anything at all, substantively. We are saying we do believe that the shareholders ought to be strengthened in what they can do.

Mr. MILLER. Mr. Chairman, I understand I now have 4 minutes and 50 seconds.

Ms. Minow, I wanted to clarify a point that was raised in questioning earlier to Mr. Price's questions. I understood your report was that because there are 27 CEO's whose salaries from 2003—or compensation increased from 2003 to 2004 by 1,000 percent, that the average compensation increase for CEO's of public corporations

went up by 91 percent. But the median compensation went up 30 percent. Is that correct?

Ms. MINOW. That is correct, thank you very much, sir.

Mr. MILLER. Okay. USA Today looked at the SEC filings of public corporations during the same period, and concluded it was 25 percent, but that was 25 percent to \$14 million. Does that sound like about the right figure?

Ms. MINOW. Yes, it does. The reason that it is so hard to get an accurate figure is that there are different methods of computing the value of the option grants, and as has already been mentioned before, there is a little bit of a sort of elephant in the boa constrictor effect there, where the option grants are exercised in 1 year, and so people look at them in different ways. But yes.

Mr. MILLER. So there are some transparency issues.

Ms. MINOW. Yes.

Mr. MILLER. Mr. Lehner, you said that so much of the debate was about the outliers, and the public outrage, and we've got to look at the median, and not the average.

Mr. LEHNER. Right.

Mr. MILLER. And that the median—do you agree with USA Today's figure, that the median compensation for a CEO of a public corporation in 2004 was about \$14 million?

Mr. LEHNER. No. Actually, the information that we looked at, using the Mercer 350 database, which is the one that is featured every year in the Wall Street Journal, as we read it, indicates that the median total pay for CEO's from 2004 to 2005 declined slightly from \$6.8 million—to 6.8 million from \$7.0 million.

Mr. MILLER. That's a pretty big difference.

Mr. LEHNER. I think Nell touched on something. I think you're probably looking at some options that were probably exercised. And that's not that they exercise those each and every year.

Mr. MILLER. So you did not count options as part of your total compensation?

Mr. LEHNER. Total return for every year, but if—again, if you're in a situation where options are exercised that may represent 10 years' worth of options, that is not to say that they get that amount each and every year.

Mr. MILLER. Okay. So, again, there apparently are some transparency issues in knowing exactly what CEO's are getting paid, or—

Mr. LEHNER. And I should say that I, you know, I think as we go forward, and the SEC presumably implements the rule next year, I think you will see less of this discussion about which set of numbers to use.

Mr. MILLER. Okay. A second point that I was intrigued by. You said that there needed to be—the compensation committees needed to be by independent directors. Now, we have dealt with that issue through mutual funds legislation.

Mr. LEHNER. Right.

Mr. MILLER. My impression was that it didn't really matter how many independent directors you had, because the problem was they weren't all that independent.

We defined independent directors by what they're not. They're not employees, they're not family members. It doesn't mean that

they're tough-minded skeptics, it just means that they don't have certain defined relationships. Is that what you mean when you say independent?

Mr. LEHNER. Generally, yes. I think the important thing for directors is that I think, especially in this day and age, most if not all of them realize that they have to approach these compensation packages with a healthy degree of skepticism.

Mr. MILLER. Okay. I think it was either Ms. Yerger or Ms. Minow—I don't recall which—but one said the greatest predictor of what a board was going to award in salaries was how many CEO's of other corporations sat on the compensation committee.

And that, in fact, it had kind of a chain reaction that if the CEO of Corporation B sat on the compensation committee, was on the board and on the compensation committee of Corporation A, then they were inclined to vote for a very generous salary for the CEO of Corporation A. And then when Corporation B looked at—reviewed salary, they looked at what Corporation A had paid.

Do you agree with—first of all, would the CEO of another corporation be an independent director, for purposes of your requirement, your proposed requirement, that—or recommendation that compensation committees be composed of independent directors?

Mr. LEHNER. They are independent by definition of the New York Stock Exchange, if they're not an employee of a company, or—

Mr. MILLER. Okay.

Mr. LEHNER.—or otherwise involved. I actually haven't looked at that data, but I would caution against guilt by association.

Mr. MILLER. Okay. One last question before it becomes red. I know there have been more philosophical discussions here than I have ever heard in Congress or perhaps in politics.

Chairman Greenspan, a conservative Republican, has sat at that table many times. And if I may translate into English—I'm not sure that Chairman Greenspan would have been allowed to testify before this committee if the Senate immigration bill had passed by that time—but to translate into English, he said that for a society to work, it's got to be fair, and it's got to be perceived as fair by the members of that society.

And the widening gap between the richest Americans and most Americans was very unhealthy for democracy. It undermined our faith in institutions, it undermined our sense that our society was fair, and it undermined our faith in democracy. Do you agree with Chairman Greenspan?

Mr. LEHNER. Well, I think we all have individual views on the widening gap, and I certainly, on a personal level, have agreed with a few of them. But I think the point of the discussion today—at least the point that we're trying to make—is you can't just apply that standard to CEO's. If we're going to have that discussion about a society, and what people get paid, and what kind of wealth they're allowed to accumulate, that's a whole separate set of discussions.

Mr. BAKER. The gentleman's time has expired. I thank the gentleman. Mr. Pearce?

Mr. PEARCE. Thank you, Mr. Chairman. The discussion is fascinating, I appreciate this. I hope, as you're talking about executive compensation and lack of productivity, and especially given Mr.

Kanjorski's comments about how much do you need a day to live, I just dearly hope you're not including Congress. I'm not sure exactly what we do produce, but I do know that my constituents wonder if I need \$454 a day to live. And so, we will slip by that without giving you all a comment. I'm afraid of what you might say.

I would agree with the transparency, that the more transparent, the better we are. What about the effect—you're worried about the effect of the undermining of our capitalist system. What about the effect of our labor leaders, executives? Are they considered executives?

In other words, in your concepts of transparency, are they considered executives, as far as performance, and as far as productive output, and as far as the compensation, and as far as compensation that is set by their peers, and as far as their ability to actually pick the people who set their pay? I see a lot of similarities.

What damage does this do, when we have no transparency, and in fact, no ability to even go in and insist on seeing any of the records? And especially when they have maybe been taking a little bit from the till from their people that is not included in their compensation package? How about the damages of that, and have you measured that, and do you contemplate that alongside the executive pay packages?

Ms. MINOW. Well, sir, my expertise is in public companies. But my sense is that, with regard to labor and other private organizations, there is a very strong system of accountability there, as we have seen with the union having parts of the union break off, and start up new. And so it seems there is a very strong market system of accountability there.

Mr. PEARCE. Are there examples of the not-strong market system working? I think I see examples where members are forbidden—for instance, in the State of New Mexico, just this year, some of the labor, small labor organizations, were going to break off. And the Governor went in and said, "We're going to put a 10-year moratorium on your ability"—they had already taken the votes.

So, first of all, he wrote all labor into one labor union. So now, instead of 10 percent of your local, you had to have 10 percent statewide for a 10-year moratorium. Now, that doesn't exactly sound like accountability and fairness. And this lack of fairness, I would appreciate my colleagues' comments on fairness and the society failing due to it. What do you say, Ms. Yerger, what about that situation that exists this year in New Mexico? It's not a pretense.

Ms. YERGER. I have, honestly, no expertise in labor issues, and I actually—

Mr. PEARCE. No, I mean, it's just a matter of fairness, it's a matter of—it's just a moral question. You don't have to know labor, it's just—

Ms. YERGER. But I think, from our perspective, we're representing investors in publicly-traded companies, and we're giving money to publicly-traded companies, and that is the focus.

Mr. PEARCE. Okay. What about the idea of fairness? Should we go in and—you remember the dot coms. You remember those companies that had no sales? They didn't yet have a product. And yet, the stock market attributed to those people's exorbitant salaries.

Should we curb the stock market from doing that? Should we go in and tell the stock market, "You're not allowed to buy this stock, and you're definitely not allowed to inflate the stock from a \$1 a share to \$200 a share before it ever has a product." So how do you resolve these kinds of questions?

Ms. MINOW. Again, I think that's an ideal situation for the market to resolve. Anybody who is dumb enough to buy stock in a company that isn't making any money deserves exactly what they get when that company tanks.

Mr. PEARCE. So, why is it necessary, then, for us to speak about executive compensation when there is no performance. Why don't those stockholders deserve what they get for investing in a company where the CEO is over-compensated? I am not sure I follow the symmetry of your argument.

Ms. MINOW. Well, you are talking about two different things. One is an IPO. The other is a situation where most of the large investors, as we have said, are essentially permanent shareholders. If they want to sell out—

Mr. PEARCE. With all respect, let's step back 1 second.

Ms. MINOW. Yes.

Mr. PEARCE. Only the IPO's are affected. Once it's out on the market, there is no longer an IPO. It was as a stock that it was driven from \$1 to \$200.

Ms. MINOW. Right.

Mr. PEARCE. So, if you would stay on that particular point—

Ms. MINOW. Yes, but—

Mr. PEARCE. Why is that different from Exxon Mobil? The price—if you're willing to buy Exxon stock—we've got transparency, and I agree with that piece—

Ms. MINOW. Right.

Mr. PEARCE. Why shouldn't you be allowed to buy Exxon stock or not buy it, and you suffer the consequences of your action, exactly the way you would with a dot com? I'm not following the symmetry of your argument.

Mr. BAKER. That's the gentleman's last question—

Mr. PEARCE. Thank you, I appreciate that.

Mr. BAKER. But please respond.

Ms. MINOW. Okay, thank you. The answer is that right now, our system is predicated on a theoretical accountability to the market with the right of shareholders to respond to elect directors, and that theoretical ability is not, in fact, in place. And I think it creates these anomalies.

Mr. PEARCE. Thank you, Mr. Chairman.

Mr. BAKER. I thank the gentleman for yielding back. Mr. Scott?

Mr. SCOTT. Thank you very much, Mr. Chairman. You know, this has been an interesting debate, and an interesting conversation. But I am reminded—and as I remind my friends on the other side of the aisle, who tend to want to make this a debate between socialism or capitalism—let there be no doubt, it might be wise for us to recall the words of Alexander Hamilton, where he said, "Indeed, our capitalistic system is here, and is determined by the free force of supply and demand. However, from time to time, it takes a centralized government to make sure it endures through the ages."

Our history is replete with examples where there have been excesses, where those of us who have been concerned about the maximum preservation of our capitalistic system have had to provide the leadership to move to do so. Need I recount the depression? Need I recount ups and downs in our economy as we have moved forward?

There are excesses here. This is not an attempt to undermine the capitalistic system. It is an attempt to protect and enhance it to make sure that it endures. We have situations here where executives out of greed—not all of them, but there are examples.

Here is one. You have Mr. Lee Raymond. He's a good guy. I have nothing against Mr. Raymond. But here is Mr. Raymond, whose executive package totals a bonus of \$100 million, while his company is underfunding the pension by \$11 billion. Don't we owe something to those pensioners, to those workers, to those people who have invested their future in that company?

Now, we have to respond to that. It's no mystery here. If we don't respond to these examples, our companies are sitting in clearly conflicting positions. Need I recall the merger and acquisition situation with RJR Nabisco? Maybe 10 years ago? But that CEO drove the company down, had a parachute, got extraordinary amounts of money, and the company took a nose dive as a result of that. That's just rank selfishness. And not all CEO's are like that. So how do we respond to that?

This bill is simply a transparency bill. All it does is simply say that let's disclose to the shareholders the information of how the compensation packages are put together, so that we can have a better system in which people will have confidence. There is no debate here over socialism or capitalism. If anything, this is a debate to preserve and enhance our capitalism.

Now, Ms. Minow, I would like to ask you if you could share with us how serious this pay-for-performance and equity and disparity is, and how devastating it is to our system at this time.

Ms. MINOW. Thank you, Mr. Scott. I would like to refer you to page two of my testimony, where we have a chart with some examples. And I am glad that you brought up the example of Lee Raymond, because it seems to me that that's a very good example of a company that should attract the attention of the U.S. Congress, because the profits of that company that supported his bonus really had nothing to do with his creating new products or coming up with better services, or even cutting costs. They were really the results of problems in the world economy with regard to oil practices and oil pricing, and he benefitted from that in a way that was, I think, detrimental to his company, his shareholders, his employees, and our economy.

If you look at that chart on page two of my testimony, you will see some examples here of companies, showing the pay packages next to the 5-year total shareholder returns. So, you have the first one, AT&T, Mr. Whitacre getting \$34.4 million with a company that had a 5-year total shareholder return of -40.32.

And I think, again, that this really severely undermines the credibility of our capitalist system. I don't know how we can expect shareholders to respond to pay anomalies like this if we don't give

them the right either to elect directors or to vote down these pay packages.

You look at Home Depot. Home Depot, I would like to bring up, had their annual meeting today, where not one director attended to hear the complaints of the shareholders, and where they cut off the power to the microphones when the shareholders got up to ask questions about the pay package there, which is an outrage. And there again, we had somebody on the compensation committee who also served on the compensation committees of the New York Stock Exchange and General Electric, with the famous retirement plan for Jack Welch.

So, if we—we have to stop them before they pay again, basically. We have to find some way to replace directors who, over and over again, agree to excessive pay.

Mr. BAKER. The gentleman's time has expired.

Mr. SCOTT. Thank you, sir.

Mr. BAKER. Thank you, Mr. Scott. Mr. Campbell?

Mr. CAMPBELL. Thank you, Mr. Chairman. First of all, I am pleased that, neither on the panel or the dais, are we talking about having the government try and figure this out. So that's good.

So, what we are talking about here is connecting the owners of the company with the compensation somehow. And I guess I want to try and dig into that a little bit, because sometimes it's easy to talk about in theory, and much harder to make it work in practice.

I mean, we currently have a system, where you get a proxy and it explains all this stuff, and you get to vote for the directors or not, and sometimes there are shareholder proposals on there, as well. Probably a lot of people throw those away, don't vote them. There are institutional shareholders, there are obviously mutual funds and pension plans, and so forth. In many cases, there will be large blocks owned by founding shareholders or whatever.

I guess why isn't that working now? I mean, why, if—and maybe to Ms. Yerger first, and then whoever else wants to, why—if we believe that this isn't working, then why isn't it working now? I mean, I would like to hear what you all say.

Ms. YERGER. The SEC pay disclosure rules were last substantially amended, I think, 13, or 15 years ago. And there have been, obviously, tremendous changes in executive pay over that period of time. We have heard the numbers. And the fact is that I think that companies have gotten—and compensation consultants have gotten—very good about identifying ways to pay without having to disclose it.

So, we're in a situation right now, frankly, where the transparency is not adequate. And I think that the SEC recognizes that. And from what I am hearing here, that is one point of agreement, is that transparency of this is a good thing. So, I mean, one problem right now is that it's very difficult to understand clearly how much, and how executives are being compensated.

Mr. CAMPBELL. So, with adequate transparency, in your view, does the current system then of electing—shareholders, etc., proxies, and so forth, have the opportunity to work?

Ms. YERGER. Well, as the Council's testimony notes, we think that it is very important that directors be accountable for these pay decisions. As a result, we are very, very, very strongly in favor of

majority voting for directors, so there is a way to hold the directors accountable for these decisions.

Mr. CAMPBELL. Okay. Ms. Minow?

Ms. MINOW. I agree with the Council's position on that. Ideally, I would love a system where shareholders got an up/down vote on executive pay, as they have in the UK. But for me, the primary priority is this adoption of the majority vote, and I would love to see the Business Roundtable push a little harder on the members who have not adopted it. Because if shareholders could vote no—

Mr. CAMPBELL. They would not have adopted what? I'm sorry, not—

Ms. MINOW. The majority voting for—

Mr. CAMPBELL. Majority vote, right.

Ms. MINOW.—so that directors couldn't serve unless they had a majority of the vote. Right now, for example, at AIG, there is a director serving who did not get a majority of the shareholder vote last year. At Blockbuster, there is a director serving who did not get a majority of the vote.

Mr. CAMPBELL. A majority of those voting, you're saying—

Ms. MINOW. Yes, yes.

Mr. CAMPBELL. Not a majority of the shares outstanding.

Ms. MINOW. That's correct.

Mr. CAMPBELL. Right, okay. And you know, the proposal of voting on compensation, the only thing is once you go down that road, I mean, you know, shouldn't—should shareholders vote on a business plan? Should they vote on the advertising budget? Should they vote on a union contract? Should they vote on pension plans that arguably go—you know, you could extrapolate that into a whole lot of other things, which becomes a little dangerous—

Ms. MINOW. I absolutely—

Mr. CAMPBELL.—initiatives in California—

Ms. MINOW. I absolutely agree with you, Mr. Campbell. I don't intend to turn corporations into referenda.

Mr. CAMPBELL. Right.

Ms. MINOW. And as long as shareholders have a say in who serves on the board, I will be happy.

Mr. CAMPBELL. Right. Okay, thank you. Mr. Lehner?

Mr. LEHNER. I think that I agree with a lot of the comments that Ann and Nell just made. I do take exception in some areas. Again, I think majority voting is, for the time being, a decision best left for companies to make.

I do think that you would be setting a dangerous precedent if you had shareholders voting directly on compensation packages. There is a reason that—a historical and a legal reason—why that has not been the case. As I indicated in my testimony, shareholders are not liable for company actions. The board and the CEO's necessarily make those decisions.

I think if you start getting into having shareholders make active decisions about who runs companies and what decisions they make and how they're going to get paid, you open shareholders themselves to litigation, and I certainly don't think the trial bar would be shy about going after large institutional shareholders if they felt like they could get some settlement money out of it. I don't think you want to go down that road.



Mr. CAMPBELL. Thank you very much. Mr. Chairman, I yield back.

Mr. BAKER. The gentleman yields back. Mr. Green?

Mr. FRANK. Would the gentleman yield to me for 5 seconds?

Mr. GREEN. Yes, sir.

Mr. FRANK. Well, I might be prepared—we will take this under advisement, but if people on the other side from this bill would rather us—instead of acquiring a shareholder vote on compensation, would rather us substitute a bill requiring a majority vote on directors, I am in a conciliatory mood.

So, you may have persuaded me with the substance, if not the specifics, and we will—when we get a mark-up, we will think about that. So that may be the alternative. We would be glad to think about that.

Mr. GREEN. Thank you, Mr. Chairman, and I thank the ranking member for hosting this hearing. And I thank the members of the panel. We want to apologize for arriving a little late. I had some pressing business, an electronic town hall meeting that I had to attend.

And many of those persons that I talked to, communicated with, I'm sure would agree with this principle, and it is that we live in a world where it's not enough for things to be right; they must also look right. We really do live in that kind of world.

Now, it may be right for CEO's to receive approximately 140 times the pay of the average worker, but I guarantee it doesn't look right to people in this country. People in this country are starting to question what we are trying to make transparent. And at some point, whether we like it or not, no matter how we justify it, people are going to rebel. They are not going to continue to allow this kind of business-as-usual to continue.

People think that there are limits, and my suspicion is that there are some people here in Congress who think that there are limits, because we have imposed limits on some others. We have done this. This is not the genesis of imposing limits. This is not the genesis of investigating to the extent that we conclude that we want to make things not only be right but look right.

So, my question will be simply this; what is wrong with transparency? Does someone have an indication from me as to what is wrong with putting all of the cards on the table, so that the persons who invest in corporations will know what's taking place, and how the money is being spent? What's wrong with transparency? Yes, sir?

Mr. LEHNER. Absolutely nothing. In fact, we support transparency. And I just—I might add that there was a question asked earlier by another member that ties very nicely into yours, and that is what is a reasonable solution? And my answer to you is the reasonable solution is to let the SEC do its job.

They have put forward, I think, a very comprehensive proposal on disclosing the executive compensation and providing transparency. We have supported that, and I think that's going to go right to the heart of a lot of the questions that have been raised here today.

Mr. GREEN. Now, if we have transparency, it has to be there for some reason. Once people are aware, they should be in a position

to do something. What would you propose that shareholders be permitted to do, once they acquire this intelligence?

Mr. LEHNER. They then have the information to make informed decisions about where they want to invest their money.

Mr. GREEN. And what would you propose that they do if they are of the opinion that their money has been used unwisely, and that there has been some abuse? What would you propose that they do?

Mr. LEHNER. Well, the first thing that I would tell them is to invest someplace else. I mean, CEO's and boards—

Mr. GREEN. Well, it's easy to say invest it someplace else—

Mr. LEHNER. Right.

Mr. GREEN. It's not—you know, it's not your money that is—that has been abused and been misused. Why can we not empower shareholders, so that they can do what we don't want government to do? Why can't we let these shareholders have some power, some influence on this process? Why would you not do that, now that they're intelligent, and they've been enlightened?

Mr. LEHNER. Sure. And it's not a question of not empowering them. I mean, I am also an investor, as I think are 83 percent of the American public.

Mr. GREEN. But do we trust the American public?

Mr. LEHNER. Oh, I think we always have to trust people to make the best—

Mr. GREEN. Well, if we trust them, why can we not allow them to acquire intelligence and to have some ability to do something with that intelligence, to act? Why can't we do that? What is wrong with giving shareholders the ability to act?

Mr. LEHNER. And I think you're right. I think the question is giving them the information and trusting them to determine for themselves what is best for them. I don't think government should be prescribing what kinds of decisions investors should be making. That's something that—investors should make that determination on their own.

Mr. GREEN. Are they not making that determination on their own after acquiring the intelligence and making some decision as to how they want their money spent?

Mr. LEHNER. I really can't answer how individual investors respond, once they are given information. They have investment advisors available to them, and plan administrators, and so forth.

Mr. GREEN. But no, let's talk about salaries.

Mr. BAKER. If we can talk about it briefly. Your time has expired, but please feel free to pose your last question, if you—

Mr. GREEN. Well, let me just end with this. We had no problem, it seems—or, there were some problems, I'm sure—but we have regulated others. The genesis of this regulation is not this bill. There are others who have been regulated. And for us to today conclude that this is inappropriate, it's something that is beyond the pale, really goes beyond the pale itself. Thank you.

Mr. BAKER. And if I may make just a brief announcement, it is my intention to recognize Ms. Wasserman-Schultz for her questions, thank the first panel, and let them be excused, and notify the second panel that, pending several votes, we are going to be over there for a few minutes. We have four votes. It will be at least 30

or 40 minutes before we're able to get back for the second panel.  
Ms. Wasserman-Schultz—

Mr. FRANK. I apologize to the second panel. We didn't expect this. Many of us will be coming back. So if you can stay, we appreciate it, and we apologize.

Mr. BAKER. Ms. Wasserman-Schultz?

Ms. WASSERMAN-SCHULTZ. Thank you, Mr. Chairman. And I am glad that my good friend from North Carolina is still here, so I can profess my undying devotion to capitalism right in front of him. I knew he would be pleased about that.

But I am also a supporter of the democratic process, and of allowing market forces to drive financial decisions like executive compensation. But you know, the comparison that Chairman Baker and Mr. McHenry have made, of—with trial lawyer awards in jury trials versus corporate board-decided executive compensation, is—it's comparing apples to licorice. I mean, it's not even oranges. They're not even in the same family.

Juries, otherwise known as people who are a part of our democratic process, and the jury process, and the decisionmaking process about jury awards and trial lawyer compensation, are all rooted in the law, I mean, which we can change, here, as Members of Congress, so, unlike shareholders' ability to impact corporate board decisions on executive compensation.

So, there is absolutely no comparison, and I think that should be noted publicly, and I would love to hear your comment on that.

And also, Mr. Baker, with all due respect, I was in the State legislature in Florida during the Florida tobacco litigation, and voted on the law several times that allowed that litigation to go forward, also a part of the democratic process.

We can note that there were 12 trial attorneys who did each make \$250 million out of a \$41 billion settlement. Combined, all 12 lawyers took 7.3 percent of the total settlement that the State of Florida received. That is far less of a percentage than most CEO's make as a total percentage of their compensation to all employees. And, although I can't give you a number, as a total percentage of the profits that each corporation makes. So, it is a political comparison, it appears, as opposed to a fair comparison.

And then, the last thing I would just state and ask you to comment on is in the May 3rd hearing, what the SEC chairman commented on, and what his concern was over executive compensation, was that often CEO's make decisions about business deals because of the nature of their compensation package. The outcomes of the incentives that are provided in their compensation packages depend upon some of the decisions and the business deals that they make. And that's a completely unfair process to shareholders, who have no say in either that decision about the business deal, or about the compensation that the CEO receives, as a result of that decision.

So, that's not the market driving that, those decisions. That is the compensation that, in many cases is excessive, driving that CEO's decision, which is unfair to shareholders. So I just wanted to see what you thought about that.

Ms. MINOW. Well, that was a very thoughtful statement. Thank you very much. With regard to the litigation point, I would just say

that my concerns about excessive—about misaligned incentives with regard to litigation relate to settlements, and not to jury trials. And I think that that's where the real problems are.

But I absolutely agree with you that we have had a lot—you know, whoever—I forget who said this was a wide-ranging philosophical discussion, but certainly a lot of tangential topics have come up, and I really appreciate your distinguishing them and putting the focus back on the one we're here to talk about.

Mr. LEHNER. I really have nothing to add. Thank you.

Ms. WASSERMAN-SCHULTZ. You don't have any comment on anything I have said?

Mr. LEHNER. No, I mean—

Ms. WASSERMAN-SCHULTZ. No opinion?

Mr. LEHNER. I generally agreed with what Nell said, and I probably couldn't say it any better. I share her concern about the litigation costs, and I am not privy to some of the deals that you were referring to, so I really couldn't comment on it.

Ms. WASSERMAN-SCHULTZ. Sometimes it's helpful just to get the facts on the table. Thank you, Mr. Chairman. I yield back the balance of my time, and I appreciate the consideration.

Mr. BAKER. I thank the gentlelady. I want to thank each of you for your participation here. I assume, going forward, that we will return to this topic in the future, and we look forward to having you back.

Ms. MINOW. Thank you, Mr. Chairman.

Mr. BAKER. Our committee proceeding will now stand in recess, pending the four matters of business on the House Floor.

Mr. LEHNER. Thank you.

Mr. BAKER. We will return shortly.

[Recess]

Mr. BAKER. [presiding] In order to proceed, we need a Member on both sides for hearing purposes. And with Mr. Miller's return, I am authorized to go ahead and reconvene our hearing. And I understand that there will be other Members returning as they clear the Floor.

So, let me welcome the members of the second panel, and express to you our appreciation for your patience and willingness to hang in there with us. As is the case for the first panel, we ask that you try to conclude your remarks in 5 minutes, and we will make your official statement part of the record.

And I turn first to Mr. Brandon J. Rees, who is the assistant director, office of investment, with the AFL-CIO. Please proceed as you choose, Mr. Rees.

**STATEMENT OF BRANDON J. REES, ASSISTANT DIRECTOR,  
OFFICE OF INVESTMENT, AFL-CIO**

Mr. REES. Thank you, Mr. Chairman. The AFL-CIO believes the Protection Against Executive Compensation Abuse Act is essential to reform CEO pay. Today, the average CEO of a major company makes 431 times the average worker's pay, up from 42 times in 1980. Executive compensation abuse takes dollars out of the pocketbooks of shareholders, including the retirement savings of America's working families.

The first problem with CEO pay is that CEO's are being paid too much relative to their individual contribution. No CEO is so talented that his or her compensation should be unlimited in size.

The second problem is that executive compensation is poorly disclosed to shareholders. Many forms of CEO pay are under-reported, and CEO pay-for-performance targets are hidden from shareholders.

The third problem is that today's executive pay packages are creating improper incentives. For example, stock options can create a strong incentive to fraudulently manipulate companies' stock prices. That is the lesson of today's Enron convictions.

Earlier this year, the SEC proposed new executive pay disclosure rules. The Commission and its staff should be commended for this proposal. However, the SEC's proposed rulemaking does not go far enough. Shareholders must be told what pay-for-performance targets are being established. Shareholders should also be told if directors have potential conflicts of interest.

We believe that the investing public shares our view. Through the AFL-CIO's executive pay watch Web site, nearly 20,000 individuals have commented on the SEC's proposed rulemaking, one of the highest totals in the history of the SEC.

The Protection Against Executive Compensation Abuse Act will go further than the SEC's proposal in several important ways. This bill will require companies to disclose short- and long-term performance targets. Under this legislation, companies will be required to call back executive pay that is improperly awarded as the result of an accounting restatement.

This bill will also require shareholder approval of executive compensation plans, and golden parachutes, an important safeguard against CEO pay abuse.

I would like to focus on the biggest component of CEO pay that is hidden from shareholders: CEO golden retirements. Every American deserves a secure retirement. Yet increasingly, companies are terminating their employees' pension plans, and transferring the risk of saving for retirement on to their workers.

At the same time, companies have turned their executive pension plans into CEO wealth creation devices. As a result, many companies have a two-tier retirement system: one for the CEO, and one for everybody else.

Leading the list is Exxon Mobil CEO Lee Raymond, who accrued an annual pension of over \$8 million. On his retirement, he opted for a lump sum cash payment of \$98 million. Meanwhile, Business Week has reported that Exxon's \$11.2 billion pension funding deficit is the biggest out of all U.S. corporations.

Let me give you more examples. At Pfizer, CEO Hank McKinnell will receive an annual pension of \$6.5 million, or a lump sum of over \$83 million. Meanwhile, Pfizer's stock price has fallen nearly 50 percent under his leadership.

United Health Group CEO Bill McGuire will receive \$5 million a year in pension benefits. That is on top of his \$1.75 billion in stock options, many of which were improperly back-dated to maximize their value.

IBM CEO Sam Palmisano's pension will be worth \$4.5 million annually, despite IBM's recently announced pension freeze for its

workers. And Home Depot CEO, Bob Nardelli, will get \$4.6 million each year in retirement, while his employees do not even have a defined benefit pension plan.

It is outrageous that the very same CEO's who are undermining the retirement security of America's working families will receive CEO supersized pensions. The Protection Against Executive Compensation Abuse Act and the SEC's proposed rulemaking on executive compensation disclosure will go a long way to expose these preferential executive retirement benefits. Thank you.

[The prepared statement of Mr. Rees can be found on page 100 of the appendix.]

Mr. BAKER. I thank you for your testimony, sir. The next witness is Ms. Christianna Wood, senior investment officer, Global Public Equity, on behalf of the California Public Employees' Retirement System. Welcome.

**STATEMENT OF CHRISTIANNA WOOD, SENIOR INVESTMENT OFFICER, GLOBAL PUBLIC EQUITY, ON BEHALF OF THE CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM**

Ms. WOOD. Thank you. Mr. Chairman, Congressman Frank, and members of the Committee, I am pleased to provide the perspective of an institutional investor on the issue of executive compensation and the legislation before you.

CalPERS is the Nation's largest pension system, with more than \$200 billion in assets. I am here to support the legislation that would help investors and shareholders know how their capital is being used.

We seek fuller disclosure and clearer communication about executive pay packages in simple English. We also want executive pay tied to performance, with clearly defined measures of success and failure in simple math. And we want companies to have a call-back policy for recapturing any form of incentive compensation that is unjustified. Executives should pay back incentive awards when it is found that the numbers used to justify the awards were inaccurate, requiring restatement.

Too often, we are paying for failure and not for performance. Just this month, CalPERS urged other shareowners to support a resolution requiring Home Depot to adopt a non-binding investor vote on its executive pay plan. That is partly because, over the last 5 years, Home Depot gave its chief executive over \$190 million, at the same time that the total stock declined 12 percent.

This last March, shareholders sued Hewlett Packard to contest a severance package of more than \$21 million, after the chief executive resigned for poor performance, and now we are told that the severance package could be worth up to \$42 million, including stock and options.

Opponents of today's bill say government shouldn't meddle in the marketplace that is working well, and that executive pay reflects honest competition for the best corporate leaders. Opponents say soaring executive compensation is merely keeping pace with corporate growth, and that pay packages appropriately reflect what the market will bear. We are told that supply and demand is what determines executive pay, much as it does Yankee shortstop Alex Rodriguez, who gets \$25 million a year.

However, supply and demand works better for ballplayers than it does for corporate executives. Baseball fans who find the price too high can vote with their feet; they can stay home. In the corporate world, shareowners can't stay home. If we sell our stocks, we are out of the game. If we're out of the game, we can't produce the investment returns that cover \$3 out of every \$4 of our people's retirement benefits.

When a CEO gets millions of dollars for running a company into the ground, when an executive takes stealth payments that we can't trace, there is a big potential impact on the retirement prospects for millions of ordinary people. We are talking about the clerks, the custodians, the technicians, the safety officers, and the public employees who entrust their nest eggs to investors like us.

And of course, taxpayers also pay more if corporate boards fall asleep at the switch. Taxpayers and CalPERS members typically don't attend company meetings, or even vote proxies. They rely on large, institutional shareowners and investors like CalPERS to watch their money. But we can't follow their money in executive compensation, as it stands now.

Big companies may say that they want to—excuse me, they may say that they pay executives a pittance, compared to the billions of dollars in profits that they generate. In response, we have learned that runaway executive compensation indicates that corporate boards aren't minding the store. And we all know that bad things happen when corporate boards don't pay attention. Boards weren't paying attention on the accounting issue a few years ago, and they are in the same fix today, with the compensation issue.

A few years ago investors testified here on behalf of what became the Sarbanes-Oxley law, which requires transparent accounting principles. That law has been good for the market, making it harder for the Enrons and the WorldComs of the world to cook the books, deceive investors, and jeopardize the life savings of millions of Americans. The bill before you today would bring that same kind of transparency and oversight to runaway executive compensation.

In a perfect world, we wouldn't need government to call companies to account for the way that they pay their executives. Since this isn't a perfect world, we are seeking a rule of law not to set salaries, but to require companies to show us the money, to show those who own the companies what they are paying executives, and why.

To sum up, we want more information than just corporate labels to tell us what's in the bottle. As owners, we have the right to know. Our financial health and the retirement security of 1.4 million members may depend on it. Thank you, and I welcome your questions.

[The prepared statement of Ms. Wood can be found on page 105 of the appendix.]

Mr. BAKER. Thank you for your comments. Our next witness is Mr. Frederic W. Cook, founding director of Frederic W. Cook & Co., Incorporated. Welcome, sir.

**STATEMENT OF FREDERIC W. COOK, FOUNDING DIRECTOR,  
FREDERIC W. COOK & CO., INC.**

Mr. COOK. Thank you, Mr. Chairman, Mr. Ranking Member, and members of the Committee. It's a pleasure to be here. I will skip my background, except to say that I am an executive compensation consultant with about 33 years of experience in advising boards and managements on executive compensation pay issues.

I will start by saying that the media has been flooded with a multitude of distorted, misleading, and often erroneous statistics given to portray U.S. CEO's and board governance in a negative light. In assessing what's right and wrong with executive compensation, it is important to start with a sound fact base.

In my presentation, I will identify, and hopefully clarify, two important issues in executive compensation that have caught the public's attention: the CEO pay ratio to the average worker; and CEO pay increases.

It is often cited in the press that the ratio of the average large company CEO's pay to the average American worker has grown threefold over the past decade from about 140 times to about 430 times in 2004. The calculations behind these statistics have been chosen to produce high CEO pay ratios for maximum propaganda effect.

First, they include realized option gains, which are the pay-off for many years of grants and rising stock prices. They are not representative of a single year's compensation.

Second, they focus on average CEO pay, not the median. Average pay is inflated above true compensation norms by a few outliers.

Third, and lastly, they compare CEO pay to the average pay of production and non-supervisory workers who, unfortunately, have not benefitted from trends in the United States and global economy as much as other American workers.

What might be a better way of calculating CEO pay ratios? We propose using the Mercer human resource consulting CEO compensation survey. This is a large, stable group of 350 companies in diverse industries and sizes, and the data has been collected consistently for over 10 years, since 1992.

With funding support from the Business Roundtable, we accessed this database on CEO pay and asked Mercer to calculate median CEO pay—not average—and break it down by component: salary, salary and bonus, annual pay, salary and bonus, and long-term, which includes stock options. But we had them compute stock options on the Black Scholes grant value, not realized gain. And I think you all know that the Black Scholes grant value will be, as part of the SEC's proposal, how options will be calculated and included in total pay, going forward. These numbers, we believe, better reflect the intention of board compensation committees in setting CEO pay levels, and in the new SEC definitions.

For the average production worker, U.S. Census Bureau data provided the median annual earnings for individuals aged 25 to 64, who worked full-time for the full year. That's a smaller group. This is more representative of the average American worker, blue collar and salaried, and it's more comparable to CEO's, who also work full-time and year-round.



What was the result of these changes in calculation? The CEO pay ratio was 90 times in 1994, not 142 times, as reported by the pay critics, and it rose to 187 times in 2004, not 430. This is a two-fold increase over the period, not three-fold, as usually reported. The estimated pay ratio went down in 2005, to 179 times. CEO pay is not always escalating upward; it does fluctuate with the market.

The CEO pay ratio actually peaked in 2001, following the peak of the tech bubble. The fact that CEO pay has been trending below its peak level for 4 years running has not been reported in the press, to our knowledge. It is possible that the critics of executive pay levels and practices use pay statistics selectively, and only when it portrays CEO's in a bad light.

Even the Wall Street Journal reported as fact last January that the average CEO's salary in the United States is 475 times greater than the average worker's salary. This is patently absurd. There are over 15,000 CEO's in the United States in public companies alone, and many more in private companies. The Wall Street Journal later corrected its errors by stating, "A Towers Perrin study found that the total compensation of the average chief executives in the United States in 2005 was 39 times the average worker."

Note the errors committed by the Wall Street Journal. They had used a statistic from a small sample of highly paid CEO's in very large companies, and they made the reader believe that all CEO's are overpaid. And they took the CEOs' total pay and called it base salary, having you believe that CEO pay is not at risk or variable with performance.

There is other material in my presentation, but my light is red, so I will cede the floor.

[The prepared statement of Mr. Cook can be found on page 66 of the appendix.]

Mr. BAKER. I thank the gentleman for your testimony. And let me start, Mr. Cook, with your observations about this apparent cycling of CEO compensation, in that along with the tech bubble, we appear to have hit a bubble in compensation in 2001. And in your view, from that point forward, speaking to the median, that there has been a slight decrease, and certainly not an increase in compensation levels, in respect to the 2001 figure.

Do you have an opinion as to the proposal now pending before the SEC on additional disclosure? And do you believe that to be a helpful proposal, moving in the right direction?

Mr. COOK. Yes, sir. I do have an opinion. I do believe it is a helpful proposal. We are in favor of enhanced disclosure, particularly of retirement benefits and perquisites that have been under-reported in the past. The—we favor the whole proposal.

The inclusion of Black Scholes option grant values in the total compensation will, in fact, confuse things a bit, because what you are doing is combining compensation that has been received, like salaries and bonuses, with compensation that is only potential, they may never receive, and may be worth a lot more. But I'm not sure there is a better answer to it. So we favor the approach that they're proposing, yes sir.

Mr. BAKER. Thank you. Ms. Wood, I know you made reference to the proposal. I assume you have additional requirements you would like to see the SEC consider as it moves forward?

Ms. WOOD. There are very few modifications that we are suggesting to the SEC. We have provided a comment letter to the SEC, and have very minor suggestions. In general, we are very supportive of the rule.

Mr. BAKER. And Mr. Rees, did you have some comment on the SEC rule?

Mr. REES. Yes, sir. As I said in my testimony, we believe the SEC should mandate pay-for-performance targets disclosure for CEO's. We believe that is information that shareholders have a right to, and that will help correct the inequities and imbalances in executive compensation.

We also believe that the SEC should retain or lower the disclosure threshold for directors' related party transactions. The SEC is proposing doubling the amount of business that the director could do with the company from \$60,000 to \$120,000. And we believe that that's just not right, that those types of transactions must be disclosed, in order to prevent conflicts of interest and self-dealing in the executive compensation process.

Mr. BAKER. Thank you. Mr. Cook, with regard to those outliers that are creating the basis for much of the public criticism on CEO compensation, I am concerned that much of the shareholders' interests are actually voted by large institutional investor pension fund groups. And there does not appear to be adequate disclosure in advance of how those large blocks may be voting.

Is there any nexus between the shareholder expression of discontent, institutional block voting of large investor groups, and any potential reform there, that might help to get at these abhorrent actors? Certainly I'm not suggesting Mr. Frank's bill goes to the point of having shareholders approve compensation, I'm not going quite there. But shareholders can deliver messages in a number of ways. What can we do about those outliers, and does that offer any potential for us?

Mr. COOK. Well, I think, sir, that that is already underway somewhat. CalPERS, I believe, will notify a company and ask to meet with them, and explain their compensation program with a view that if you don't like the response that you receive, you will withhold votes from directors, or put them up on the abuse list.

So, the idea of institutional shareholders expressing their will beforehand, I think, is a reasonable idea and is underway.

Mr. BAKER. Well, in that light, then, if what the additional disclosures, which will be made available under the implementation of the SEC rule, with market forces using that information appropriately, Ms. Wood, don't you think that gets us where we need to be, if you, as a CalPERS representative expressed to the board of a company that you find dissatisfaction with their practices?

Ms. WOOD. We own 7,000 companies worldwide, and let me say that we—it would be virtually impossible to engage all of them to find out the kind of detail we would need, in order to withhold a vote in an extreme circumstance.

Mr. BAKER. Thank you. My time has long expired. I have been given this order for recognition. Mr. Sherman?

Mr. SHERMAN. Thank you. I will try to use my 5 minutes the best way I can. I am surprised, first, that these hearings are focusing exclusively on executive compensation. We ought to be doing more

to give investors the information they need, and that information needs to be definitive and audited and, in some cases, industry specific.

And I will use these hearings as a chance to once again say that we need a lot more information than we are getting in the financial statements which, after all, only include the information thought relevant by investors over 150 years ago. The income statement, the balance sheet are the same documents as the horse and buggy era. Oh, we've got a funds flow statement, but that's just the same information shuffled differently.

We need to know what the backlog is of a major manufacturer, what the employee turnover rate is, what the same store sales are, month after month or year after year, from a major retailer. And we need a system in which these and many other terms have a specific, clear, universal definition, that they are reported periodically, and that that information is audited.

But since all we are talking about here is executive compensation, let me say that we have to get away from this bizarre cult of the CEO. To say that whether the Miami Heat win the playoffs depends upon Shaq is mostly true. To say that whether a Buick works depends to the same degree on the chairman of General Motors is to ignore the hard work, dedication, and skill of tens of hundreds of thousands of GM employees.

It is simply absurd to say that the whole up or down in a company's stock is dependent upon the CEO, and that a huge share of that up of any increase should go to the CEO.

We shouldn't be looking at just the fluctuation in the rate of pay of CEO's, it does go up or down. But we should note—and this is similar to what the third witness had to say, a little differently—that for the top 100 U.S. companies, it's 170 times the average worker. Now, if you have—go to smaller companies, you get a somewhat smaller number. But compare that to Britain, where it's 22 times, Japan, where it's 11 times, the fact that it may fluctuate from 170 up to 190 and down to 150 masks the overall, which is that we pay our CEO's rather well.

This is—those who question this pay, though, give us this relatively absurd pay-for-performance idea. Sounds great. But look at what that does to how we run our companies. We are now going to say, "Produce the way Shaq does. It's one series, seven games. There is no tomorrow, Shaq." We want to say that to our CEO's? Do we want to say it's all about one quarter, or at most, one season? We should say that to our basketball teams; I'm not sure that that's the message we want to get across.

I would rather have a board of directors look at how the CEO is performing. Maybe he is doing a great job and they're in a bad industry. You know, if you're running a gold mining company these days, you could be dumber than a pound of gold and you would still be counted as a great CEO. It's absolutely absurd to have a formula-driven—short-term formula-driven—pay package for CEO's.

But in order to have the board of directors determine that compensation, wouldn't it be nice if we had democracy? Tom may have called it, what, excessive democracy. What about a situation—now, look at the situation now. You can't run for the board of directors

unless you're nominated by the nomination committee. I think, if that's a good system, let's bring it into politics.

"Why in the hell is somebody running against me on the November ballot? The committee didn't put his name on the ballot." If we just had the Sherman for Congress committee determine who could be on the ballot, that would be the end of excessive democracy in the 27th Congressional District.

How about a system where it's a lot easier to run and a lot easier to get your information into the hands of shareholders? How about a situation where the re-election rate for boards of directors is at least as low as it is for Members of Congress? You know, we get criticized, we get re-elected, what, 96, 97 percent? Would that the directors only get re-elected 96 percent of the time. We would have some democracy.

So I look—and the final point I want to make is Democrats have tended to be wary of national standards, particularly, for example, in the lending area. If we don't have national standards for the protection of minority shareholder rights, for the protection of shareholder democracy, then Wyoming and Nevada and Delaware can lead a race to the bottom that will go lower than the bottom. And we will end up with nothing but a take it or leave it approach. If you don't like how the company is run, you can't vote for a new board of directors, so you're stuck.

But that means that if you don't like the board of directors at General Motors, you have to sell short its hundreds of thousands of hard-working employees. How dare you turn to the American people and say, "You can't invest in the hard work of a group of 50,000 or 100,000 hard working Americans if you don't like the board, and you can't vote one way or the other against the board."

We need a system of national standards protecting shareholder democracy. And if we leave it to each State fighting for the right to have the most protection for the existing CEO's, then from time to time, companies will change their corporate domicile from Nevada to Delaware and back again, and—

Mr. BAKER. Your time has expired.

Mr. SHERMAN.—we will thereby avoid excessive democracy. I apologize for not framing a question for the witnesses, and I yield back.

Mr. BAKER. I thank the gentleman.

Mr. FRANK. Would the gentleman yield just for 10 seconds, so we don't misquote the witness? The phrase I heard from our witness was super-democratize. We were told not to super-democratize.

Mr. SHERMAN. That would be the right phrase, yes.

Mr. BAKER. Ms. Hooley?

Ms. HOOLEY. Thank you, Mr. Chairman. I have a question for any of the panel members. As we—hopefully, the adoption of new rules with more transparency, how is it going to work that it's going to be audited? How are we going to know that they really are transparent in their figures and their numbers?

And the second question is, should we even have options for the top executives, if that confuses the issue?

And third, how do we look at—how do we make compensation committees not have a conflict of interest? I mean, so often it is—even if you say there has to be some separation, it seems like there

is still a very cozy relationship where, you know, I have you over to my house, or I fly your wife in my plane, or there seems to be some connection, even if you aren't serving on one another's boards.

So, how do we get some—in the compensation committees, how do we get some independence for those committees? Any one of the panel members, or all of you. Yes?

Mr. REES. I would be happy to respond on those points. First, on the question of how can we ensure that proxy statement disclosure on executive pay is accurate, the SEC is considering in its rule-making whether the compensation discussion and analysis portion of the proxies should be filed under Sarbanes-Oxley and certified by company CEO's, or furnished, meaning simply provided without that higher standard.

The AFL-CIO strongly believes that the CEO pay disclosure should be filed and subject to the higher disclosure standard.

Secondly, on the question of stock options, we believe that companies should be paid using performance shares, actual shares of stock, that would only vest meeting a performance benchmark, combining the goal of ownership with performance. The problem with stock options is that they can be back-dated, as we have seen at companies like United Health and two dozen other companies that are investigated by the SEC. They can also reward share price volatility, which is a measure of stockholder risk.

Lastly, on the question of how can we make compensation committees more independent and provide vigorous oversight of CEO's, that's why we need, as the Executive Compensation Abuse Act has proposed, shareholder approval of executive compensation plans as a safeguard for shareholders.

And then, secondly, as Nell Minow proposed in the earlier panel, we need director election reform. We need to require that compensation committee directors receive a majority vote, and we also need to empower shareholders to be able to nominate their own director candidates in what's known as equal access to the proxy.

Ms. HOOLEY. The rest of you?

Ms. WOOD. Several points. First, on the point of audit, this is desperately needed. And the back-dating of stock options is a very timely item in the newspaper to remind us that the audit of compensation practices is currently quite poor.

And this is—it gets to the heart of, also, why section 404 of Sarbanes-Oxley is so important. If there was ever an item to demonstrate the need for companies to have better financial controls and internal controls, this would be the item.

In terms of stock options, there is a decline in the use of stock options, and in preference for restricted shares, performance shares, etc. And that has come about as a result of the implementation of the stock option expensing. And in general, I think this is probably a good thing, but it demonstrates that there are many different ways to incent and award executives. Stock options is just one way to do it. And many companies are finding other methods. And actually, Mr. Cook is an expert on that, so I will let him opine on the plethora of ways in which boards give money to executives.

On the conflicts issue, we are very concerned about conflicts on comp committees. We think that the standards for dependence need to be raised. We think that situations like Home Depot, where

five of the six comp committee members are either sitting or retired CEO's, and the correlation of that to oversized pay needs to go away, and that, frankly, investors need to have more say in the composition of those committees. Absent majority voting, it's not likely that investors will ever get that right to really weigh in on directors, themselves.

And I entirely agree with Mr. Rees on director election reform. Until we have that, really there is no teeth for shareowners in many of these initiatives. Thank you.

Ms. HOOLEY. Mr. Cook?

Mr. COOK. Well, we have had a lot of unanimity among our panelists today, let's try and stir things up a little.

Ms. HOOLEY. Good. Okay.

Mr. COOK. You know, Ms. Minow, who is not here now—but if she was, I would still say—CEO's don't select the members of the compensation committee, not in any committee or board that I know of. They are all independent, and they are chosen by the nominating committee of the board, without input from the CEO. They are independent of the CEO.

Second, stock options are a great incentive vehicle. They are perhaps the greatest derivative instrument ever invented by man to align the interests of the employees with the shareholders who own the company but do not manage the company.

Okay, can they be abused? Sure, they can be abused. They can be abused by making them too big, and they can be abused by back-dating them, which is a—if it isn't illegal, it should be. It's an immoral act, it's fraudulent, and it's robbery. Okay, that doesn't make you ban them. They have a role in many companies' compensation programs, and should be encouraged.

Now, Mr. Rees's point about the SEC taking the compensation committee report, they want to take it away from the compensation committee and give it—and make it the responsibility of the CEO and the CFO, both of whom are excluded from the compensation committee executive sessions. In any comp committee that I attend, the CFO is never in there. So how can the CFO affirm to the accuracy of the committee's report, which won't even be the responsibility of the committee?

If you want to make the committee independent, which we all do, let them keep the report under their signature, not under the signature of the CEO. Thank you.

Ms. HOOLEY. Thank you.

Mr. BAKER. The gentlelady's time has expired. Mr. Frank?

Mr. FRANK. Mr. Cook, under the current practice, how much influence does the CEO have over the selection of members—people to be members of the board?

Mr. COOK. Sir, in honesty, I don't know. I advise compensation committees—

Mr. FRANK. Okay, if you don't know, then we could move on.

Mr. COOK. I don't—

Mr. FRANK. But here is what I would say, is this. The fact that the CEO may not pick the particular members of the compensation committee wouldn't impress me if he or she has picked the pool from which they come. So, if I picked eight people, and three of

them are going to be in the compensation committee, I don't much care which three it is.

And I appreciate that you don't know. I will tell you that the information we have is that CEO's have a lot of influence over who picks the compensation committee. I mean, I am just reading about Disney now, when Mike Eisner got people kicked off the board.

So, I think the problem is that while it may be the case that the CEO's don't pick which of their directors are the members of the compensation committee, they have created the pool out of which they come.

The second question is I agree with options, particularly with regard to mid-level and over-level employees and workers, though I do want to again say, we were told that if we required companies to expense the stock options, the heavens would fall. We have done so. I saw heaven last night, it was still up there. I think this is one more case of alarmism.

But here is the question. For the CEO, say that I am a CEO and I am making \$6 million a year. And I've got a nice driver and a car, and I've got a pretty good set of compensations. Why in the world does somebody then have to do more to get me to align my interests with the company?

I must say, it seems to me that you're describing a character flaw. I am the CEO of a company. I have got pride of craft. I really care about this company. I am getting a lot of money. Do we really need to then give them stock options in addition, to get them to do the job for which they are so highly paid?

Mr. COOK. Well, I will try and answer it quickly. If we have a target compensation package of \$6 million, let's say, that's—

Mr. FRANK. No, I am asking—please don't reframe my question. Suppose I've got a salary of "X" million, whatever it is, why do I need an incentive on top of whatever the salary is?

Mr. COOK. To align your interests with those of the shareholders—

Mr. FRANK. So, in other words—

Mr. COOK.—rising stock prices.

Mr. FRANK. In other words, you are making a stronger condemnation of CEO's than any I have heard from some of the most radical people. These highly paid influential people are not, on their own, going to align their interests with the stockholders, unless we give them extra money on top to do that. And I am appalled by that.

I don't know about you, but I don't get an extra amount to align my interests with the voters and the taxpayers. The cab driver doesn't get an extra amount to get me where I'm trying to go. I mean, this notion that you have to bribe these people to do the job for which they are paid in the first place troubles me.

I mean, without stock options, if we are paying someone several million dollars a year, we can't count on her to consider herself aligned with the people who are paying her salary?

Mr. COOK. Stock options are included in the \$6 million or \$7 million—

Mr. FRANK. I'm saying if they are not. Why do you keep doing that? I'm saying can you not envision a situation in which there is

a flat salary of “X” million dollars, and that should be enough so you don’t have to give options to them?

Mr. COOK. No client of mine, no public company in their right mind, would pay their CEO \$6 million in salary and let it go at that.

Mr. FRANK. Well, I—why do you have to incentivize them to do what they’re getting paid to do in the first place?

Mr. COOK. It’s called “align their interest”—

Mr. FRANK. No, why do you have to do that? I know what it’s called. You’re not a dictionary.

Mr. COOK. Because they’re not an owner, they’re an employee.

Mr. FRANK. Oh, the CEO is just another employee. Well, again, you have made the sharpest condemnation of CEO’s, that the most highly paid and the most powerful people in the company have to be incentivized to do their job.

Let me ask—you’re a major investor. I was somewhat surprised to have the Business Roundtable tell me that shareholders who are dissatisfied have one option, as far as he’s concerned, which is to sell the stock. As someone who has stock in a lot of operations, how would that affect what you do? What would—if, every time you were dissatisfied with a particular set of corporations, if your only recourse was to sell the stock, what effect would that have on your ability to produce for your—for the people with whose interests you are relying?

Do you get a lot of options, by the way? Ms. Wood, do you get a lot of options?

Ms. WOOD. I have no options.

Mr. FRANK. Well, do you screw your people that you work for? Or do you align yourself with them? I mean, are you some special kind of person who doesn’t need to be paid extra to align yourself?

Ms. WOOD. I enjoy working on behalf of the 1.4—

Mr. FRANK. Well, I wish more CEO’s were like you. But please go ahead.

Ms. WOOD. Your question, I think, is very important. I have over 25 years of investment management experience, and a number of designations that give me the ability to say that it would be against our fiduciary duty to sell those securities and just walk away. We would lose our voice, and we would impair the returns of the fund.

Ultimately, that burden would fall on the taxpayers. And as I said in my statement, three out of every four dollars of the benefits that we pay to our members come from the investment returns. They don’t come from the taxpayers, they don’t come from the employees that pay into the system; they come from the investment returns. It is our duty to manage that money, and that is why we are a permanent owner, and selling stocks as a result of these types of situations is not an option.

Mr. FRANK. Thank you. Let me just ask one more, if I could, if that’s an all—the owners of stock being told, “If you don’t like it, sell it,” what about workers who have 401(k) or other plans in which they were—and we may be changing that in the future—required to put some of their money into company stock?

Are there workers who are, in effect, sort of captives of the company stock? What would their recourse be, if they were unhappy



with corporate governance? Can everyone sell their stock freely, or did they make a free choice to buy it in the first place?

Mr. REES. Well, the problem is that if I wanted to screen the companies that I invested in, based on those that paid reasonable compensation, I would have a very difficult time finding enough companies to get a diversified portfolio.

The problem is that this is a systematic problem of executive compensation, and that, on average, whether you think it's \$6 million or \$12 million, it's too high. And the practices that have resulted in these levels of compensation are—need to be reformed. And that's why we need greater accountability.

Mr. FRANK. This last question, there was some reference to union leaders' pay. How many union leaders get sort of incentive pay so they will do their job right? Are you familiar with the number?

Mr. REES. The—it's an interesting fact that every single employee of a union's compensation is disclosed at the Department of Labor. And yet, CEO's are arguing over whether the top five employees of a company should disclose their compensation or not. And if you go to the AFL-CIO's Web site at—

Mr. FRANK. But is it common to give them whatever the equivalent of options would be? I mean, do they get—

Mr. REES. We get no options.

Mr. FRANK. In other words, let me put it this way. If you're a union leader, and you sign up more members, do you get a percentage of the dues to incentivize you to align yourself with the people?

Mr. REES. No, we do—

Mr. FRANK. Okay.

Mr. REES. We represent working families, because we believe it—

Mr. FRANK. Well, I appreciate that. I guess what I am—I must say that I am disturbed to be told that there is—if one group of American CEO's who peculiarly have to be given extra incentive to do their job—and the fact that they are hired and highly compensated and highly respected is apparently not enough to get them to align themselves with the people they're working for. Thank you, Mr. Chairman.

Mr. BAKER. Mr. Miller?

Mr. MILLER. Thank you, Mr. Chairman. Just a couple of questions. It's late, and the TV cameras are gone. I think we're all tired.

There have been—there was a lot of discussion earlier today in the first panel from the other side of the aisle about how those of us who are questioning CEO compensation just do not respect adequately the capitalist system, and the wealth that's being built. And the example that was being given repeatedly was Bill Gates and Microsoft.

You referred, Mr. Cook, to the CEO as an employee. My understanding of the source of Mr. Gates's wealth is the equity he owns in Microsoft, not his compensation as the executive of Microsoft. Is that correct?

Mr. COOK. That's correct. Mr. Gates never got a salary, I don't think, of more than \$500,000 and a bonus of around the same amount. I don't think he ever got a stock option in his company. He was a founder. When we use the term CEO in these discussions, I think we are talking about a professional employee who did not found the company, who came in—

Mr. MILLER. So the story of Microsoft and Bill Gates is not pertinent to this discussion?

Mr. COOK. Yes, sir.

Mr. MILLER. That was what I thought, too. A couple of other points. In the earlier panel, there was a remarkable difference between Ms. Minow, who agreed with a USA Today study of 2004, and Mr. Lehner—I got it right this time, I apologize for getting it wrong earlier—apparently looking at exactly the same documents filed with the SEC by exactly the same people, at exactly the same time.

And Ms. Minow and USA Today concluded that the median compensation in 2004 for the CEO's of public corporations was \$14 million, and Business Roundtable concluded that it was \$7 million. And both of them said, basically, that there were some elements of compensation that were kind of hard to value.

Now, we have talked about the need for transparency, and everyone seems to agree with that. But not being able to tell whether the compensation is \$7 million or \$14 million strikes me as a pretty big problem with transparency.

Mr. Cook, is that—do you think that difference is largely due to the transparency issues?

Mr. COOK. No, sir. I don't think it's due to the transparency issue at all. I think it's a difference between counting option gains when they're realized, versus counting the Black Scholes value when they're granted.

I think—I don't know, because I didn't see it—but I know that Ms. Minow at Corporate Library counts realized option gains, and that's where they come up with their number. And I think that's what the USA Today report should do. I think that's a very anomalous thing, because it takes many years of grants and lumps them into one year, and it also makes it subject to the rising market.

If we have a good stock market for the rest of this year, then the proxy statement next year may show higher increases in pay, just because executives chose to exercise their options from a long time ago this year.

Mr. MILLER. Well, according to Ms. Minow's study and the USA Today study—first of all, that was median. They didn't use the average. Ms. Minow said the average for that year, the average increase, was not a 1 percent, because there were 27 outliers that had increases of 1,000 percent.

But based upon their earlier—it had gone up more between 2003—than between 2002 and 2003 and 2001 and 2002. And immediately after Enron and WorldCom, it slacked back off to about 9 percent, and then it went up to a 15 percent increase, and then to a 30 percent increase. But increases that are substantially above what most Americans are getting is the norm, not a 1-year anomaly.

Mr. COOK. I can explain that. The Corporate Library uses a very large database, about 3,000 companies that comprise the Russell 3,000, okay? They compute using stock option realized gains. And they do compute the median, that's what they focus on. They agree with us, that median is better than average.

The median, under their database, went up 15 percent in 2003—

Mr. MILLER. Right.

Mr. COOK.—30 percent in 2004, and 11 percent on their preliminary data of 500 companies in 2005. They hadn't completed their full research yet. That uses realized option gains.

We had been in a period of rising stock prices since the collapse of the tech bubble in 2000 and 2001. That's what is showing that up. They have a very large database, and they just computed using realized gains. This problem, I think, will disappear next year, when the SEC new rules go in requiring Black Scholes values, because I think everybody will shift to the Black Scholes value.

Mr. MILLER. Okay. One last question; I think the red light is about to go on. There has been some discussion about the need for an independent—for having compensation committees all be independent directors. And I questioned earlier what we mean by independent.

Independent does not mean—tough-minded skeptics, it won't mean people who are going to take the CEO by the lapels, and challenge them. It means simply people who do not have certain legally-defined relationships.

And the criticism of many, including, I think, Ms. Wood and Mr. Rees, is that they are not independent enough. Ms. Wood, do you believe that the compensation committees are sufficiently independent? And if not, how do we make them more independent? How do we make them more—how do we make them live up to their duty to the shareholders, to the owners, and not to the CEO's? And Mr. Rees, the same question to you, sir.

Ms. WOOD. Well, first of all, many of them reach the technical definition of independence. And you know, I mean, it is the case that—and I will just use Home Depot as an example. You know, there are relationships among the boards of these—it's been well documented. But they all reach a technical definition of independence.

And let me get to the second part of your question, which is how do we create more responsive compensation committees, more responsive to the needs of the shareowner, and the voice of the shareowner? I think there are a couple of things that can be done.

One is, first of all, for shareowners to use the very blunt tool of withholding their vote, which is unfortunate, because that's the only tool we have right now.

Second is to go down the path of the UK model, where shareowners get an up or down vote to approve the compensation committee report, and as a result, make a statement about the compensation of the company.

And barring that, I think the only other thing is more election reform, and more majority vote proposals, such as I understand the majority vote proposal passed at Home Depot, for example.

So, it is possible that, you know, if a majority of shareowners were to say—were to withhold their vote from a compensation committee chair at Home Depot, that next year it's very likely, if the majority vote were implemented, that that person couldn't be on the board any more, or that person would have to submit their resignation to the nominating committee, and that that person should get the message that they need to lead the board, that they haven't acted on behalf—in the best interest of shareowners.

So there are a couple of things—there are a few things we can do, I think, to strengthen the voice of the owners.

Mr. FRANK. Was that a binding vote by Home Depot, or an advisory vote? You said a majority vote passed at Home Depot, was that binding or advisory?

Ms. WOOD. I believe it was not binding. Am I correct?

Mr. REES. That's correct.

Ms. WOOD. Yes.

Mr. REES. And if I could just add to your point about disclosure, the numbers that are publicized and the numbers that are disclosed to shareholders, and the methodologies that Mr. Cook was referring to, all of those exclude what is perhaps the single biggest component of CEO pay.

Professor Lucien Bebchuk at Harvard Law School has estimated that the typical CEO receives over one-third of their total compensation in the form of retirement benefits. CEO's are receiving supersized pensions that have preferential terms that are not offered to other workers. And I think that's unconscionable, particularly at a time when companies are terminating their pension plans and returning them back to the government through bankruptcy.

Mr. FRANK. So we're aligning their interest with the workers once they have retirement? Maybe we're aligning their interests with their wives.

Mr. REES. Someone made the point that CEO turnover has increased over the years to just 4 years in office. And I would suggest that may be because we are paying them too much, and they have no more reason to work.

Mr. FRANK. They—

Mr. REES. They would rather retire to an island in the Caribbean, or to a ski slope in Aspen.

Mr. BAKER. And with that word, the gentleman's time has expired. Mr. Miller?

Mr. MILLER. Just one last point on the relatively short tenure of many CEO's. We have discussed the need for a longer-term view by CEO's, and at the same time pointed to four-and-a-half year average tenure, as evidence that they are being held accountable.

In fact, those seem to push us in different directions, that if they're going to be judged by a standard that is that immediate, and their compensation is based on how they're doing right now, it is certainly going in a different direction from what Mr. Lehner suggested the Business Roundtable's position was, that they needed to be pushed toward a long-term view of how the corporation is doing.

Mr. BAKER. And I think, not to raise a new subject, but we ought to get away from quarterly earnings reports and talking heads impacting Wall Street, saying—

Mr. FRANK. Yes.

Mr. BAKER.—CEO "X" didn't meet Wall Street expectations, his stock goes in the tank, he gets fired, and it serves no one's economic interests.

Mr. FRANK. Or, let me say even worse, when I read in the paper that their stock went down because they only met expectations.

Mr. BAKER. Yes.

Mr. FRANK. And they're expected to exceed expectations, which isn't good English, and certainly isn't good corporate governance.

Mr. BAKER. I would even go so far as to say there might be people who utilize financial tools to meet expectations or exceed them when the economic reality was not the same.

And so I think we've got a lot of homework here to do, and I want to—

Mr. MILLER. Mr. Baker?

Mr. BAKER. Yes.

Mr. MILLER. I can't help but notice that you waited to criticize the TV talking heads until after the Bloomberg and the—

Mr. BAKER. Oh, I will do it all the time. I have no—

Mr. MILLER.—cameras have left.

Mr. BAKER. I want to thank each of you for your participation. We will return, I'm sure, to the subject in future meetings. And Mr. Frank?

Mr. FRANK. Yes, I just wanted to particularly express my appreciation for waiting. But we've taken this seriously, and there were members here, and what you've said is heavy in its impact.

So, we appreciate you being here, and it wasn't wasted time, although we apologize for the delay.

Mr. BAKER. Thank you again. Our meeting stands adjourned.

[Whereupon, at 4:43 p.m., the committee was adjourned.]



# **A P P E N D I X**

May 25, 2006

**Opening Statement of the Honorable Richard H. Baker**  
**“Protecting Investors and Fostering Efficient Markets: a**  
**Review of the SEC Agenda”**  
**May 25, 2006**

Today the Committee meets for a second day of hearings on “Protecting Investors and Fostering Efficient Markets: a Review of the SEC Agenda”. This hearing is pursuant to the invocation of Committee Rule 11 by the minority.

Investor protection and the fostering of efficient markets are two concepts that need not be mutually exclusive, as this Committee, and this Congress has proven on more than one occasion. In order for markets to be efficient, investors have to be secure in the knowledge that the playing field is fair and transparent. When it became obvious to members of Congress that additional oversight of the accounting industry was necessary, this committee acted. When it became clear that there were conflicts of interest among analysts and investment banking this committee acted. When revelations of impropriety surfaced at Fannie Mae, this committee acted. Now we are faced with another scandal, another egregious revelation of alleged abuse of trust, I speak of the recent DOJ indictment of the largest and most profitable securities class action plaintiff firm, Milberg-Weiss.

The allegations contained in the indictment paint a truly disturbing picture of greed and a complete violation of trust and fiduciary duty of its clients by this firm. The indictment includes details of kickbacks to



numerous “plaintiffs”. The alleged kickbacks total in excess of \$11 million dollars. Total attorney fees allegedly collected from kickback cases total \$216 million dollars. Upon bringing forth the indictment, United States Attorney Debra Wong Yang stated, “This case is about protecting the integrity of the justice system in America. Class-action attorneys and named plaintiffs occupy positions of trust in which they assume responsibility to tell the truth and to disclose relevant information to the court. This indictment alleges a wholesale violation of this responsibility.” While this indictment is shocking, it should not necessarily come as a surprise to those who follow these issues. In a 1993 interview in *Forbes* magazine, Bill Lerach, a former prominent partner for Milberg-Weiss stated, ““I have the greatest practice in the world because I have no clients. I bring the case, I hire the plaintiff. I do not have some client telling me what to do. I decide what to do.” This is utter hubris. Mr. Lerach’s statement shows a clear disregard of his fiduciary duties to his plaintiff class clientele.

According to an industry study, Milberg-Weiss served as lead or co-counsel in approximately 43% of securities class action suits from 1995-2005. The firm alone was responsible for over \$6.5 billion dollars in settlements and raked in over \$1.7 billion dollars in fees and expenses. They are clearly the industry leader. This indictment simply reinforces a belief I already maintained, and that is our tort system, and securities litigation in particular, has become so irresponsible as to serve not as an asset, but a liability to the investor, consumer, and our nation’s markets and economy. Even a cursory look at the recent trends in securities litigation is enough to raise significant concerns. The aggregate securities class action settlements skyrocketed from under \$500 million in 1997 to over \$9 billion in 2005. To

further put this in perspective, in 2004 the aggregate fees earned by trial lawyers were approximately 40 billion dollars. That same year the aggregate salary for Forbes 500 CEOs was 1/8<sup>th</sup> that amount, or \$5.1 billion. To put a finer point on this comparison, in 2005 the average salary for a Forbes CEO had climbed to \$10.9 million. The average lawyer payoff in Florida alone for the Tobacco settlement was a staggering \$233 million. That's not per lead partner, that's per attorney! These dollars are paid by corporations, which means each and every one of these dollars come out of the pocket of shareholders.

In addition to violating the trust of investors, these skyrocketing legal costs have a devastating effect on the competitiveness of our capital markets globally. Firms are choosing to list overseas and raise capital in Europe and Asia rather than face the menace of the predatory plaintiff's bar in the U.S. Tort costs as a percentage of GDP in the United States are 2.2%, over double that of most other industrialized countries. France, England, Japan, Spain and Germany are at or below 1.1%. If the markets are to retain the already fragile confidence of investors and remain competitive in the global race for capital, then Congress must respond to the abuses and excesses of our securities litigation system.

Congressman McHenry and I will be introducing today the Securities Litigation Attorney Accountability and Transparency Act of 2006. This legislation incorporates common sense and incremental reforms that will serve the dual purposes of allowing the U.S. to maintain its lead role in the global capital markets while giving appropriate parties – defrauded

investors-- the opportunity for redress of alleged harms. The bill if enacted will:

- Permit courts to select lead plaintiffs' attorneys through an auction process to ensure the most qualified legal representation at the lowest cost and, thus, guarantee greater returns to investors.
- Require disclosure to courts of conflicts of interest between plaintiffs and plaintiffs' attorneys and permit courts to disqualify attorneys for unmanageable conflicts in order to ensure that all investors have the strongest legal advocacy.
- Permit courts to hold losing parties' attorneys accountable for attorneys' fees to ensure that plaintiffs, not attorneys, are in control of litigation.

Securities class actions should be a means for investors who believe they have been harmed to seek restitution, not a conduit for money to flow from the pocket of investors to the credenzas of plaintiffs' attorneys.

Opening Statement of Representative Gwen Moore  
 House Financial Services Committee Hearing, "Protecting Investors and  
 Fostering Efficient Markets: A Review of the S.E.C. Agenda"  
 May 25, 2006

I am proud to be a cosponsor of The Protection Against Executive Compensation Abuse Act. This legislation includes several provisions that would significantly protect the interests of investors by providing substantial disclosure of the company's executive compensation policies. Specifically, it would require:

- Full Disclosure of Top Executive's Compensation including *any and all* types of compensation paid (or to be paid) to top executives (such as pensions, golden parachute agreements, personal use of private jets/company apartments and other currently hidden compensation);
- Full Disclosure of Compensation Policies for Top Executives including the short and long-term performance measures or targets that will be used to determine the top executive's compensation (and whether such measures were met in the preceding year); and
- A Company Policy for Recapturing Any Form of Incentive Compensation That Subsequent Financial Results Show Are Unjustified such as when the company pays bonuses/grants stock options to executives for meeting performance targets only to later learn that these numbers were inaccurate and must be restated.
- Clear and Simple Disclosures of Compensation Statements on the Company's Website, including disclosures on the company's compensation filings made to the SEC.
- Separate Shareholder Approval of Golden Parachute Packages. The bill would also require that shareholders separately approve any additional compensation for top executives that coincides with the sale or purchase of substantial company assets.

Excessive executive compensation has recently hit home in my district. Earlier this year, Delphi Corp. announced it would shut down their plant in Oak Creek, which employs 1,200 workers in the Milwaukee area. After the announcement, Delphi proceeded to file a motion with a federal bankruptcy judge to cancel its labor contracts with the United Auto Workers (UAW) in response to the UAW's recent rejection of Delphi's offer to slash workers' wages and benefits.

However, under its Key Employee Compensation Program, Delphi would give 600 executives and managers \$510 million in compensation, while rank-and-file workers lose their jobs. The Delphi executive incentive plan includes six-month performance bonuses that could result in executives earning a bonus for half a year's good results regardless of whether the company operates at a loss for the full year.

In addition, there is also an "emergence bonus plan" under which executives can earn cash bonuses up to 250% of their salaries if the reorganizes or sells a large portion of its assets.

Clearly, shareholders need to have greater understanding and oversight of these matters. I am sure they would be interested to know of the glaring inequity between Delphi's treatment of its retiring executives and laid off workers. I am especially outraged at Delphi's blatant misuse of the bankruptcy process as a tool to throw out the wage and benefit plans negotiated by its rank and file employees in good faith.

The most egregious aspect of their plan is the executive severance program. Delphi's severance plan would provide 21 officers with 18 months of salary and bonuses, 89 senior managers would receive a year of pay and bonuses, and 373 executives would be eligible for a full year's salary. If just 30% of executives took their severance, the cost would be \$30.5 million, enough to provide each of the 1200 Oak Creek employees with over \$25,000.

This legislation must be advanced in order to provide a more transparent and fair deal to the shareholders of all publicly traded companies, especially those workers who own a stake in their company.

**Frederic W. Cook & Co. Testimony  
Before the House Financial Services Committee on  
Executive Compensation**

May 25, 2006

The Honorable Michael G. Oxley, Chairman  
The Honorable Barney Frank, Ranking Member  
House Financial Services Committee  
Room 2129, Rayburn House Office Building  
Washington, D.C. 20515

Dear Chairman Oxley and Congressman Frank:

Thank you for the invitation to participate in the Committee's Panel on Executive Compensation.

**Our Credentials**

Frederic W. Cook & Co. provides management consulting assistance to corporations and their compensation committees in developing compensation plans for their executives and key employees. Our focus is on performance-based compensation programs (salaries, annual incentives, long-term incentives and stock ownership programs) that help companies attract and retain key employees, motivate and reward them for improved performance, and align their interests with those of shareholders.

Formed in 1973, our firm has served over 1,800 clients from offices in New York, Chicago, Los Angeles, and San Francisco. Many of our clients are among the largest companies in the world, including over half of Business Week's 250 largest market capitalization companies. Other clients have been small to mid-size firms, private companies and start-up ventures.

We hold ourselves responsible to be a thought leader in compensation design and practice innovations, and an advocate of leading "best practices" in the governance of executive compensation. As such, we regularly contribute to the knowledge base of compensation practice and philosophy through research, speeches, articles and essays.

**Introduction**

The media has been flooded with multitude of distorted, misleading and oftentimes erroneous statistics chosen to portray U.S. CEOs and Board governance in a negative light. In assessing what's right and wrong with executive compensation, it is critical to establish a sound base of facts. In our presentation we identify and clarify two important issues in executive compensation that have caught the public's attention: **CEO Pay Ratios** and **CEO Pay Increases**.

CEO Pay Ratios and Long-Term Trends

It is often cited in the press that the ratio of average large-company CEO's pay to the average American worker has grown three-fold over the past decade, from about 140x in 1994 to about 430x in 2004<sup>1</sup>.

The calculations behind these statistics have been chosen to produce high CEO pay ratios for maximum propaganda value. **First**, they include realized option gains, which are the payoff from many years of grants and rising stock prices. They are not representative of a single year's compensation. **Second**, they focus on *average* CEO pay, not the *median*. Average pay is inflated above true compensation norms by a few outliers. **Third**, they compare CEO pay to the average pay of production and non-supervisory workers who, unfortunately, have not benefited from trends in the U.S. and global economy as much as other American workers.

What might be a better way of calculating the ratio of CEO pay to average workers? We propose using the **Mercer Human Resource Consulting's CEO Compensation Survey**. It is a large, stable group of 350 companies in diverse industries and sizes, and the data have been collected consistently since 1992. With funding support from Business Roundtable, we accessed this database on CEO pay and asked Mercer to calculate **median** CEO pay (not average), and break it down by component, namely, median base salary, median annual cash pay (salary plus earned bonus), and median total pay (annual cash pay plus stock options and other long-term incentives). For stock options, we had them substitute Black-Scholes option grant values for realized gains. These better reflect the intention of board compensation committees in setting CEO pay levels, and new SEC definitions of total pay.

For the average production worker's pay, we substituted the median annual earnings for individuals ages 25-64 who worked full-time for the full year.<sup>2</sup> This is more representative of the average American worker (blue collar and salaried) and comparable to CEOs, who also work full time and year round.

What was the result? The CEO pay ratio was **90x in 1994**, not 142x as reported by pay critics. And it rose to **187x in 2004**, not 430x. This is a **two-fold increase** over the period, not three-fold as usually reported. The estimated ratio actually went down to **179x in 2005**, as median total pay for CEOs declined slightly to \$6.8 million from \$7.0 million.<sup>3</sup> The CEO pay ratio actually peaked in 2001, following the peak of the tech bubble. The fact that the CEO pay ratio has been trending below its peak level for four years running has not been reported in the press to our knowledge. It is possible that the critics of executive pay levels and practices use pay statistics selectively and only when it portrays CEOs in a bad light.

<sup>1</sup> "Executive Excess 2005," Sarah Anderson and John Cavanagh, Institute for Policy Studies; Scott Klinger and Liz Stanton, United for a Fair Economy.

<sup>2</sup> Census/Bureau of Labor Statistics.

<sup>3</sup> 2005 worker earnings statistics are not yet available from Census/BLS, but by aging 2004 earnings at just 1.3% (i.e., equal to rate of increase from 2003 – 2004) the ratio decreased from 187x in 2004 to 179x in 2005.

A chart of CEO pay ratios over an 11-year period using these more-defensible statistics from Mercer Human Resources Consulting is shown on Exhibit 1. You'll note in looking at this chart that: (1) the CEO **salary multiple** has hardly moved; it was 24.9x 11 years ago, and it was 25.5x in 2005; (2) the CEO **total cash ratio**, reflecting annual performance bonuses, moved up one-third from 46x to 63x; but (3) the big increase over the period came in the form of at-risk stock option and other equity grants, tied to market appreciation, which raised the **CEO total pay ratio** from 90x to 179x over 11 years, a growth rate of 6.5% per year.

This situation of increased performance-based incentives and at-risk equity grants is quite different than just saying that CEO pay went through the roof at the expense of the average worker.

Now I would like to address the second part of the problem with the CEO pay ratio debate. Regardless of the ratio used, whether 430X, 500X, or 179X, it only applies to the CEOs of very large companies. The public has been subject to such an incessant drumbeat of negative criticism about escalating CEO pay that it now accepts as given that all CEOs are paid "too much."

Even The Wall Street Journal reported as "fact" on January 31, 2005, that "*The average CEO's salary in the U.S. is 475 times greater than the average worker's salary.*" This is patently absurd. There are approximately 15,000 public company CEOs in the U.S. and many more heading private companies. The WSJ later corrected its error by stating, "A Towers Perrin study found that the total compensation of the **average chief executives in the U.S. in 2005 was 39 times the compensation of the average worker**, while the average CEO of Standard & Poor's 500 companies made 212 times the average worker. This article incorrectly said that the average CEO salary in the U.S. was 475 times the average worker's salary."

Note the errors committed by The Wall Street Journal. They used a statistic from a small sample of very highly paid CEOs in very large companies and made the reader believe that *all* CEOs are overpaid. And they took the CEO's *total pay* and called it *base salary*, having you believe that CEO pay is not at risk or variable with performance.

#### CEO Pay Increases

The Committee's statement regarding "The Problem of Executive Compensation" cited a 30% increase in median CEO compensation and 91% increase in average CEO compensation in 2004 (Corporate Library)<sup>4</sup>.

The distorting issues are similar in this case. **First**, realized option gains and payouts of other long-term incentives were included, so compensation may represent the payoff of many years of service and not a single year's compensation. **Second**, average increases are misleading because they are skewed by outliers. The sample was defined as "2000 of the largest US corporations", but the 91% increase in the average was driven by just 27 CEOs whose increases were over 1,000% because they were off a very low base.

<sup>4</sup> "Corporate Library 2004 Pay Survey" Paul Hodgson



A more meaningful baseline statistic was constructed using the same Mercer Human Resource Consulting's CEO Compensation Survey referenced earlier. We found that CEO total compensation increased 13% in 2004 and decreased 3% in 2005<sup>5</sup>. For reference, Corporate Library found that median CEO compensation increased 11% in 2005 (down from 30% in 2004).

We found CEO total compensation to have a 5-year compound annual growth rate of 5.5% and a 10-year compound annual growth rate of 9.6%, reflecting changes in the size of companies and their financial and market performance.

Detailed data are provided in **Exhibits 2 and 3**.

### **Conclusions**

Public debate on CEO pay would be enhanced if all parties agreed to: (1) use large data bases of companies, like Corporate Library, and use them consistently over time; (2) use the grant date present value of new stock option grants, not realized gains; (3) focus on market medians, not averages that are distorted by outliers; and (4) report the results consistently every year, whether or not they support a particular point of view.

This more even-handed approach, however, may not serve the purposes of those who attack CEO compensation as a means of undercutting the trust of the American people in our system of board governance. It is likely the critics will continue on their path of selective and distorted reporting of CEO pay abuses. If so, we should expect and welcome the business community to defend itself by:

1. Countering misleading facts with better facts,
2. Advocating pay for performance and executive ownership,
3. Extending performance-based compensation broadly in the organization, and
4. Promulgating and defending best practices, while marginalizing and excoriating bad practices.

Are there CEO pay abuses? Of course there are, just as there are abuses of power in all large institutions. If there was not the potential for abuse in our free enterprise system, we would not have a free enterprise system. The job of those who defend our systems is not to defend the abusers but to encourage the adoption of evolving best practices in corporate governance and executive compensation so that additional and burdensome regulation is not required

### **Comments on "The Protection Against Executive Compensation Abuse Act"**

We do not believe the proposed Act is necessary or desirable. We favor full disclosure of top executives' compensation along the lines of the SEC proposal. This is well underway and will happen.

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<sup>5</sup>All incumbents; continued incumbents increased 17% in 2004 and 1% in 2005.

We do not support requiring shareholder approval of an "Executive Compensation Plan." This usurps the traditional role and responsibility of the independent board of directors acting as the shareholders' representatives. Shareholders already are required to approve the use of equity in compensation plans. Combining this with enhanced SEC disclosure of all executive compensation (cash, stock, benefits, SERPs, perks and other special benefits, and termination/change-in-control payments) is all that is needed to give directors the added discipline and incentive they need to reform bad practices and adopt good ones.

Disclosure of performance measures or targets used to determine top executive compensation is already part of the proposed SEC rules. And requiring companies to "claw-back" incentive payments based on fraudulent accounting is already part of the Sarbanes-Oxley Act.

**What Would Be Helpful?**

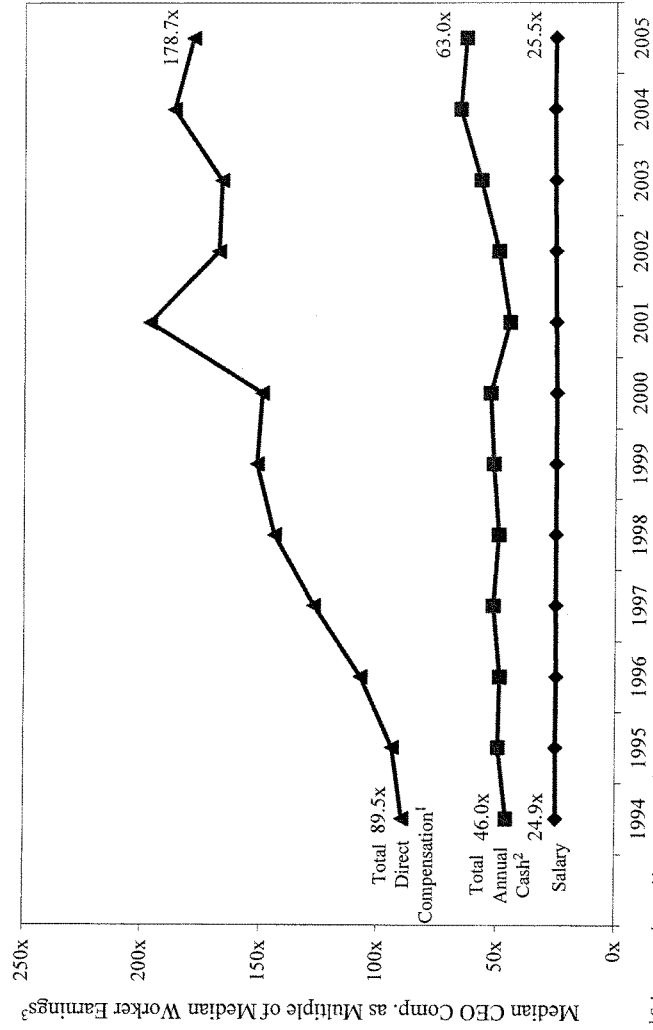
There are areas where your Committee could be helpful to boards and managements. This includes governmental action to encourage the adoption of good practices by reducing the tax incentives for perks. You also could encourage the spread of concepts of performance-based compensation and equity incentives to lower levels of the company, thereby narrowing the CEO pay gap in companies, not by lowering the top, but by raising the bottom.

I would be pleased to advance these ideas with you in a follow-up memo or discussion if desired.

Thanks you,

Frederic W. Cook

## CEO Pay Ratio (vs. Worker Earnings)



<sup>1</sup> Salary, earned annual bonus, grant value of restricted shares and stock options, and target value of payout of any other new performance-based cash or equity awards  
<sup>2</sup> Salary and earned annual bonus  
<sup>3</sup> Wage and salary for full-time workers ages 25-64 who were employed for the whole year.

Source: Mercer 350 database (350 large-cap general industrial and service companies with median revenue of \$10 billion); U.S. Census/BLS

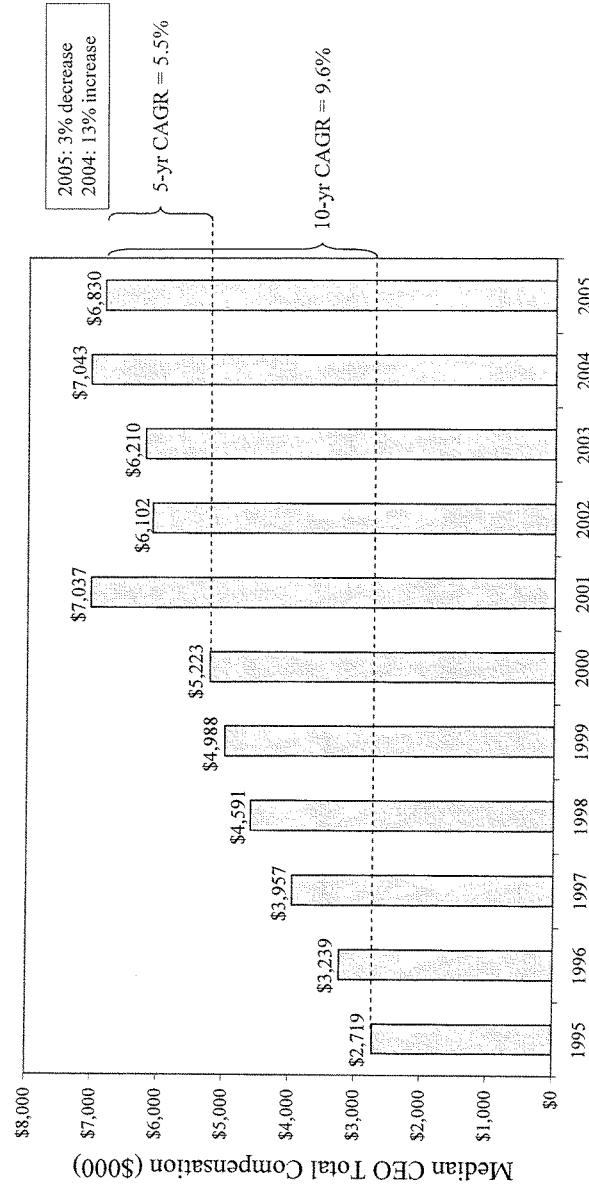
**MERCER MEDIAN CEO PAY TREND DATA**  
(\$000)

	1995	2005	CAGR
<i>Mercer 350 Median CEO Pay (\$000)</i>			
1. Salary	\$729.0	\$975.0	3.0%
2. Bonus <sup>6</sup>	703.0	1,433.7	7.4%
3. Long-Term <sup>1</sup>	1,287.5	4,421.5	13.1%
4. Total	\$2,719.5	\$6,830.2	9.6%
<i>Mercer 350 Median Financial Metrics (\$mil)</i>			
1. Revenue	\$5,055.7	\$7,627.5	4.2%
2. Net Income	261.5	590.5	8.5%
3. Market Cap	4,324.6	10,078.4	8.8%
4. TSR Index	1.00	3.32	12.7%

<sup>6</sup> Derived median

## Growth in Median CEO Total Direct Compensation

- Total compensation includes salary, earned annual bonus, grant value of restricted shares and stock options, and target value of earmout of any other new performance-based cash or equity awards.



Source: Mercer 350 database (350 large-cap general industrial and service companies with median revenue of \$10 billion); all incumbents.



Business Roundtable

*Protecting Investors and Fostering Efficient Markets*  
*A Review of the SEC Agenda:*  
*Executive Compensation*

*Before the House Financial Services Committee*

May 25, 2006

Thomas J. Lehner, Director of Public Policy  
Business Roundtable

Written Testimony and  
Comments for the Record

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### Introduction

**Business Roundtable** [www.businessroundtable.org](http://www.businessroundtable.org) is an association of chief executive officers of leading U.S. companies with over \$4.5 trillion in annual revenues and more than 10 million employees. Our companies comprise nearly a third of the total value of the U.S. stock market and represent nearly a third of all corporate income taxes paid to the federal government. Collectively, they returned more than \$110 billion in dividends to shareholders and the economy in 2005.

Roundtable companies give more than \$7 billion a year in combined charitable contributions, representing nearly 60 percent of total corporate giving. They are technology innovation leaders, with \$86 billion in annual research and development spending – nearly half of the total private R&D spending in the U.S.

We have been leaders in the area of Corporate Governance and we supported the Sarbanes-Oxley reforms in 2002 because we knew investor trust and confidence had to be restored to the marketplace. Also in 2002, we first published *Principles of Corporate Governance*. <http://www.businessroundtable.org/pdf/CorporateGovPrinciples.pdf> and the following year we established the Business Roundtable Institute for Corporate Ethics at the Darden Business School at the University of Virginia. In 2003 we published *Executive Compensation, Principles and Commentary*. <http://www.businessroundtable.org/pdf/ExecutiveCompensationPrinciples.pdf>

Our principles on executive compensation call for executive compensation to be closely aligned with the long-term interests of shareholders, and to include significant performance-based criteria. Furthermore, board compensation committees should be composed of entirely independent directors, and they should require executives to build and maintain significant equity investment in the corporation. Finally, companies should provide complete, understandable, and timely disclosure of compensation packages, and the SEC proposal is consistent with our recommendation.

With respect to the SEC proposed rule on compensation disclosures, we support the proposal because we believe in transparency and providing shareholders with useful information. In our comment letter to the SEC (attached), we suggested ways to prevent misleading information from being disclosed with respect to stock options, and we also pointed out that any new requirements should not disclose proprietary information about a company's product or client development plans that could hinder competitiveness.

#### The Current Debate

In the current debate on executive compensation, a key question is how to define performance. We believe there has been too much emphasis on short-term stock gains, and not enough recognition that other performance-based criteria are applied. It is our belief that determining this performance-based criteria, and setting overall executive compensation, should properly remain with Boards and compensation committees as they are in the best position to set the standards and evaluate the performance of executives.

Concerning recent coverage of CEO compensation, there has been a great deal of misleading information promoted by critics and reported in the media. There are over 15,000 publicly traded companies in the United States – and if one believed even a few of the stories written you would think all CEOs make tens, if not hundreds, of millions of dollars, each and every year. This is not the case, and we believe this type of sensationalism is damaging to the debate, our corporations, and our shareholders.

#### Compensation Trends

This is not the first time the issue of CEO pay has attracted so much attention. In the early 1980's when stocks were underperforming, activists sought to limit the salaries of CEOs and tie their pay to the performance of the company. Congress obliged by placing tax consequences on annual salaries above \$1 million, and CEOs were given stock options as incentive to perform. As the market has increased dramatically in the last 15 years, so has CEO pay. Reformers got exactly the system they wanted, but now,



ironically, many are critical of the results and they are crying foul. They claim that CEO pay exceeds company performance.

In fact, the data does not support this. Research using the Mercer 350 database shows that over a ten year period from 1995 -2005, median total compensation for CEOs has increased 9.6%, while the market cap has increased 8.8%, and total shareholder return has increased 12.7% (chart attached). These numbers show a direct correlation between levels of pay, market increase, and shareholder return. This trend was confirmed by a recent article in the *The New York Times* (attached) that cited an New York University/Massachusetts Institute of Technology study showing a direct correlation between CEO compensation and the value of the top 500 companies between 1980 and 2003.

We have identified two flaws that contribute to the erroneous figures that inflame this debate. First, many of the statistics cited are averages, not medians. As we all know, these are misleading because of extreme instances of the pay scale – one outlier skews the average for all. The second involves how stock options are counted. When options are exercised, they often represent a decade worth of accumulated stock; and in the current debate they are characterized as a single, annual amount of compensation. Furthermore, when counting options we should use the amount when granted, and not the realized gains when exercised. We should also point out that some of the pension payments highlighted in the media represent 30 years or more of service to the company, and deferred compensation payments also represent amounts CEOs have earned over a lengthy period.

We all agree that shareholders provide capital and in effect own companies, but the key distinction is recognizing that they don't run them. Shareholders invest in companies, profit from their growth, and in exchange for not having any liability for company actions, decisionmaking is necessarily left to Boards and CEOs.

The U.S. corporate model has been the envy of the world by providing centuries of growth, jobs, and return for investors. In our view, legislative proposals (such as H.R. 4291) calling for shareholder approval of compensation plans is unwise and ultimately unworkable.

If we adopted a system where small groups of activist shareholders used the process to politicize corporate decisionmaking, the consequences could very well be destabilizing. Some activist groups who disagree with corporate positions on Social Security reform, health care reform, and free trade policies, for example, seek to “super-democratize” corporations to the point of having shareholders remove directors, choose CEOs, and determine company policies and levels of pay. This is a slippery slope that should be avoided - if this model were applied to CEOs, then by extension the public would determine salaries for news anchors, movie stars, athletes and elected officials.

#### Support for the Current System

Despite the rhetoric from critics of the current system, we know of no instance where a Board is willing to pay a CEO more than they are worth, or more than the market price bears.

The performance metrics applied are not limited to stock price – they also include annual profits, job creation, restructuring plans, remaining competitive in the global marketplace, and subjective factors such as company community activities, crisis response efforts, and leadership.

One telling statistic about CEO accountability comes from our own members: In 1985 the average CEO tenure was over 8 years, today it is 4 ½ years. Many CEOs hired today are expected to produce in a short period of time – and while they are well paid if successful, they are replaced if they fail. *The Washington Post* recently cited a Booz Allen study that shows that CEO turnover in 2005 was above 15%, the highest level in a decade (article attached).

We cannot state what the appropriate level of CEO pay should be, nor can we answer the question “How much is enough?” That would require a broader social debate on wealth in our society. But within the context of corporate governance, setting CEO pay is a function of the Board of Directors, and should remain that way. We do not believe in encouraging an environment where companies become gridlocked while executives pander to numerous shareholder constituencies, and companies would operate with the same efficiency as Congress. It is important to remember that these are private corporations designed to make a profit – and public investment in them is voluntary. We should not confuse the term “Public Companies” with the public sector.

The key to this process is to give investors the information they need to make informed decisions to buy, hold, or sell their investments. That is the rationale behind the SEC initiative on compensation disclosures, and one of the reasons why we support it.

Today’s CEOs recognize that as leaders of global companies, they have tremendous economic and social responsibility. That’s why we reference the \$110 billion in annual dividends paid to shareholders, and the \$7 billion given annually to charity. Following Hurricane Katrina, *The Wall Street Journal* referred to industry’s philanthropic effort as a “Private FEMA” (article attached).

In conclusion, we are sensitive to extreme cases about CEO compensation reported in the media, and we continue to develop and promote best practices for our members to follow. Independent boards and shareholders will deal with extreme cases and we should not ruin our free market system because of a few rogues. We strongly believe that the current system has worked well, and should not be changed. By any historical measure, shareholders have enjoyed enormous returns by investing in the market, and that is the ultimate incentive for Boards and CEOs to perform well.

Thank you for your consideration and if you have any questions, please feel free to call on me.



## Business Roundtable

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 Suite 800 Facsimile 202.466.3559  
 Washington, DC 20036-3001 Website businessroundtable.org

**BY EMAIL**

April 10, 2006

Ms. Nancy M. Morris  
 Secretary  
 U.S. Securities and Exchange Commission  
 100 F St., NE  
 Washington, DC 20549-9303

Henry A. McKinnell, Jr.  
 Pfizer Inc.  
 Chairman

Kenneth I. Chenault  
 American Express  
 Company  
 Co-Chairman

Edward B. Rust, Jr.  
 State Farm Insurance  
 Companies  
 Co-Chairman

John J. Castellani  
 President

Larry D. Burton  
 Executive Director

Johanna I. Schneider  
 Executive Director  
 External Relations

**Re: File No. S7-03-06, Release No. 33-8655, 34-53185  
 Executive Compensation and Related Party Disclosure**

Dear Ms. Morris:

This letter is submitted on behalf of Business Roundtable ([www.businessroundtable.org](http://www.businessroundtable.org)), an association of chief executive officers of leading U.S. companies with over \$4.5 trillion in annual revenues and more than 10 million employees. Member companies comprise nearly a third of the total value of the U.S. stock market and represent nearly a third of all corporate income taxes paid to the federal government. Collectively, they returned more than \$98 billion in dividends to shareholders and the economy in 2004. Roundtable companies give more than \$7 billion a year in combined charitable contributions, representing nearly 60 percent of total corporate giving. They are technology innovation leaders, with \$86 billion in annual research and development spending – nearly half of the total private R&D spending in the U.S.

The Roundtable supports the Securities and Exchange Commission's efforts to "provide investors with a clearer and more complete picture of compensation to principal executive officers, principal financial officers, the other highest paid executive officers and directors." In this regard, the Roundtable has issued *Principles of Corporate Governance* (2005) and *Executive Compensation: Principles and Commentary* (2003), both of which endorse providing shareholders with meaningful and understandable information about a company's executive compensation practices. We appreciate the opportunity to provide our views on the Commission's proposed amendments to the disclosure requirements for executive and director compensation, related party transactions, director independence, and other corporate governance matters and disclosure requirements (the "Proposed Rules"). As discussed in more detail below, we believe that there are some aspects of the Proposed Rules that can be improved including, among other things, eliminating the proposed disclosure requirement concerning non-executive officers and revising the proposed disclosure requirements concerning total compensation, deferred compensation, retirement and change in control and corporate governance.

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## **I. Compensation Disclosure & Analysis**

The Roundtable supports the Commission's efforts to enhance disclosures about the material elements of companies' compensation objectives and policies for their named executive officers ("NEOs"). In the past few years, many compensation committees have sought to provide more meaningful disclosures in their compensation committee reports. The Commission's emphasis on, and the additional detail proposed for, the Compensation Disclosure & Analysis will further this process.

We believe, however, that such disclosure should continue to be included in a report of a company's compensation committee. A company's compensation committee is legally responsible for decisions regarding the compensation of its NEOs. In this regard, securities market listing standards, state law and compensation committee charters generally provide that it is the compensation committee or the independent directors who review CEO performance, determine CEO compensation, and make recommendations to the board about non-CEO compensation and other compensation plans.

Moreover, the disclosures to be provided in the proposed Compensation Disclosure and Analysis (e.g., how determinations are made as to when equity awards are granted and factors considered in decisions to increase or decrease compensation materially) are particularly within the knowledge of compensation committee members, not company management. Similarly, the certifications set forth in Sections 302 and 906 of the Sarbanes-Oxley Act of 2002, required by chief executive officers and chief financial officers with respect to periodic reports, should not cover these narrative disclosures. CEOs and CFOs are not in a position to certify the processes and methodologies employed by the compensation committee in setting their own compensation. It is the compensation committee – not the CEO or CFO – who can best provide the disclosures set forth in the Proposed Rules (e.g., "why does the company choose to pay each element," and "how does the company determine the amounts [(and, where applicable, the formula)] for each element."). Thus, we believe that the narrative disclosures regarding the compensation objectives and policies for NEOs should continue to be provided over the names of the members of the compensation committee and should not be covered by the certifications required by Sections 302 and 906 of Sarbanes-Oxley. Consequently, we believe that these disclosures should continue to be "furnished" rather than "filed" with the Commission.

## **II. Compensation Disclosures for Up to Three Non-Executive Officers**

The requirement in the Proposed Rules to disclose the total compensation and job description of up to three employees who are not executive officers and whose compensation exceeded any NEO's total compensation will not provide useful information to investors in making voting and investment decisions and raises a number of concerns. First, since it is highly unlikely that the compensation committee is the decision-maker with respect to non-executive employees' compensation, it is unclear as to what purpose this information is intended to serve. Second, disclosing the compensation of certain non-executive officer employees may cause companies competitive harm by assisting competitors in targeting recruiting efforts at companies' top performers. Moreover, disclosure of non-executive employee compensation may lead valued employees to seek new positions at non-U.S. firms and hedge funds in order to protect their privacy and avoid public disclosure of their compensation. Third,

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the type of employees that may need to be reported under this disclosure will vary greatly by industry (e.g., sales personnel, investment bankers, entertainers, etc.), making it less likely that the information will be readily comparable. Finally, whereas NEOs' total compensation is typically uniform with respect to individual compensation elements and proxy disclosure, non-executives' compensation elements may be wholly different, provide no relative basis of comparison and, without context, would only cause employee morale issues and controversy within a company.

For these reasons, we believe that the disclosure of non-executive officer employee compensation information is unnecessary to the Commission's goal of providing investors with a clearer and more complete picture of the compensation earned by a company's senior management and of the compensation decisions of the company's compensation committee. Therefore, we urge the Commission to not adopt this aspect of the Proposed Rules.

### **III. Summary Compensation Table**

The Roundtable understands the Commission's desire to provide investors with quantifiable information regarding aggregate compensation paid to NEOs. However, we believe that, given the complexity of executive compensation, it is preferable to divide the Total Compensation Column into two separate columns to distinguish between compensation in a particular year that is *actually received* by NEOs and that which NEOs have been given the *opportunity to earn* at some point in the future. An example of our suggested approach is set forth in Exhibit A to this letter. This two column approach responds to concerns that the proposed Total Compensation Column requires companies to combine amounts paid and amounts that at best may be paid at different points of time far in the future, or at worst may never be paid because performance or other criteria are not met. Thus, we believe that this two column format will provide shareholders with a better and more accurate understanding of NEOs' total compensation distinguishing compensation actually paid in a given year and that which only has the potential to be paid in the future, but that may never actually be realized.

### **IV. Identification of the Most Highly Compensated Officers**

Under the Proposed Rules, companies will determine their three most highly compensated executive officers based on the amount disclosed in the Total Compensation Column rather than the aggregate of the Salary and Bonus columns as required under the current rules. We believe that the current approach is preferable, as the use of total compensation will result in factors unrelated to annual compensation governing the executive officers whose compensation is disclosed. For example, under the Proposed Rules, an executive who has been with the company for many years and accrued a substantial nonqualified deferred compensation account may be included as an NEO even though this executive's salary and bonus are much lower than that of other executives with more significant responsibilities.

We also believe that determining NEO status based on the proposed Total Compensation Column could lead to significant year-over-year volatility in a company's NEOs. A single payment in a given year could alter the individuals who must be disclosed in the Summary Compensation Table. This could prevent shareholders from receiving timely information on the specific compensation paid to the most important executive officers. The existing rules already allow companies discretion to exclude a

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highly compensated individual who is not the CEO due to unusually large bonus amounts or other amounts that are not part of a recurring arrangement (Reg. S-K, Instructions to Item 402(a)(3)). That discretion should continue.

## **V. Deferred Compensation Disclosures**

### *A. All Other Compensation: Earnings on Deferred Compensation*

The Proposed Rules require inclusion in the Summary Compensation Table of "[a]ll earnings on compensation that is deferred on a basis that is not tax-qualified." This is in contrast to the Commission's current rules requiring disclosure of earnings on these amounts only to the extent that earnings are "[a]bove-market or preferential," which we believe is the appropriate standard.

Market rate earnings on deferred compensation amounts are not compensation. They reflect an NEO's decision to defer his or her compensation, which is already reported in the year it is earned. This amount could otherwise be invested and receive a market rate return. The proposed disclosure also may discourage NEOs from electing to defer compensation. For these reasons, the Commission should continue to require the disclosure only of "[a]bove-market or preferential" earnings on deferred compensation. To the extent that the Commission may be concerned about the way in which the current standard is being applied, that concern can be addressed by codifying existing staff interpretations regarding what is "above-market" rather than requiring disclosure of market rate earnings.

### *B. Nonqualified Defined Contribution and Other Deferred Compensation Plans Table*

The proposing release indicates that, in an effort to "provide a more complete picture of potential post-employment compensation," the Commission is proposing to require disclosure of a Nonqualified Defined Contribution and Other Deferred Compensation Plans Table ("Deferred Compensation Table"). This Table will require additional (and at times repetitive) disclosure of compensation paid and earnings on such compensation. The Roundtable believes that this additional disclosure should not be required because it will result in "double counting" of amounts previously disclosed and because such amounts do not reflect compensation actually paid to a company's NEOs.

"Double counting" will occur because deferred amounts are included in the Summary Compensation Table in the year such compensation is received and deferred, and will be included again in the proposed Deferred Compensation Table. Our concern is not alleviated by the provision in the Proposed Rules that companies should disclose in a footnote to the Deferred Compensation Table amounts that previously have been reported as compensation.

Moreover, amounts disclosed in the Deferred Compensation Table are not annual compensation but instead amounts that an NEO has elected to defer, often due to individual tax planning considerations. These amounts represent an investment that the NEO has made in the company, not compensation. Thus, the aggregate balance and earnings thereon have no correlation to an NEO's annual compensation. Instead, an NEO's balance under a deferred compensation plan is the equivalent of a bank

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account where the NEO has deposited certain amounts. However, unlike deposits with federally insured banks, these amounts are "at risk" – dependent on the company's future, just as shareholders are with respect to their shares – since these are unfunded liabilities on a company's balance sheet. Disclosure of these balances could deter such deferrals, thereby undermining an important method for linking NEOs' and shareholders' interests.

## **VI. Retirement Plan and Change in Control Disclosures**

### *A. All Other Compensation: Increase in Pension Value*

The Roundtable does not believe that the Commission should require disclosure of "[t]he annual increase in actuarial value of [tax-qualified defined benefit and supplemental employee retirement] plans. "Actuarial values are heavily impacted by factors other than compensation, including an NEO's tenure with the company and an NEO's age. Moreover, the determination of actuarial values requires assumptions to be made concerning a variety of factors. Two identical pension plans could be determined to have significantly different values depending on the particular assumptions made in attempting to calculate the value of each. The resulting disclosure will not be meaningful to investors nor result in disclosures that can be readily compared between companies. Moreover, pension plans typically are offset by a company's tax-qualified plans, an NEO's Social Security benefits and similar plans made available through an NEO's prior employer.

If the Commission nevertheless determines to require disclosure of increases in actuarial values, we suggest that such information be included in the Retirement Plan Potential Annual Payments and Benefits Table ("Retirement Table") instead of the Summary Compensation Table. The increase in pension value is similar to the types of information to be disclosed in the Retirement Table and is wholly unrelated to the types of compensation information required to be set forth in the Summary Compensation Table.

### *B. Retirement Plan Potential Annual Payments and Benefits Table and Change in Control Disclosures*

The Roundtable supports the Commission's efforts to provide additional disclosure regarding specific pension benefits available to NEOs. However, we believe that the Proposed Rules are unnecessarily detailed with respect to the information required to be included in the Retirement Table. We are concerned that the Proposed Rules will result in excessive, highly detailed disclosure that, because of the multitude of assumptions involved, will be nearly impossible for companies to compile and for investors to understand. Moreover, because retirement plans vary greatly, we do not believe that these disclosures will be readily comparable, thus reducing their utility to investors. We believe that any requirements in this regard should instead be principles-based.

Similarly, we are concerned that proposed Item 402(k), which will expand disclosure requirements regarding termination and change in control provisions, will result in voluminous disclosure based on hypothetical estimates of change in control payments. In this regard, it may be impossible to accurately estimate many of these payments and requiring their disclosure may well increase liability. We therefore encourage the



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Commission to revise Item 402(k) to remove the requirement that companies disclose "the estimate[d] payments and benefits that would be provided in each termination circumstance."

## **VII. Related Party Transactions**

We appreciate the Commission's efforts to update and simplify the related party transaction disclosure requirements under Item 404 of Regulation S-K. In particular, we support increasing the Item 404 disclosure threshold from \$60,000 to \$120,000. However, with respect to the proposal to require disclosure of a company's policies and procedures regarding related party transactions, we note that many companies already include these policies and procedures in their codes of conduct. Accordingly, we encourage the Commission to permit companies to cross-reference to such information on a company's website rather than requiring duplicative disclosure in a company's proxy statement. Section 303A.10 of the New York Stock Exchange (NYSE) Listed Company Manual requires listed companies to adopt codes of conduct and publicize the codes by posting them on their corporate websites. Thus, we encourage the Commission to conform its proposed disclosure requirements accordingly.

## **VIII. Corporate Governance Disclosures**

We commend the Commission for proposing to consolidate and update the myriad of corporate governance disclosure requirements into proposed Item 407 of Regulation S-K. However, we have some concerns with respect to proposed Item 407(a)(3), which would require disclosure of "any transactions, relationships or arrangements not disclosed [under Item 404(a)] that were considered by the board of directors of the company in determining that the applicable independence standards were met" (*emphasis added*). As discussed in more detail below, such disclosure is overly broad and unnecessary.

Several current requirements contain, or permit companies to adopt, thresholds whereby certain relationships are not required to be disclosed. For example, current Item 404(b) of Regulation S-K requires disclosure of, among other things, certain business relationships where the amount involved is "in excess of five percent of (i) the registrant's consolidated gross revenues for its last full fiscal year, or (ii) the other entity's consolidated gross revenues for its last full fiscal year." Similarly, under Section 303A of the NYSE's Listed Company Manual, a company may adopt categorical independence standards delineating those relationships and transactions that the company has determined are *per se* immaterial with respect to director independence. Relationships and transactions that fall within those standards are not required to be disclosed. Companies must publicly disclose these categorical standards and thus investors are aware of the criteria applied by boards of directors in determining a director's independence. If a relationship does not fall within these standards, and the director is nevertheless determined to be independent, companies must disclose the relationship and the basis for such determination.

Proposed Item 407(a)(3) does not contain any such threshold and instead requires disclosure of every "transaction, relationship or arrangement" not already disclosed but considered by a board. Boards of directors take seriously their responsibility to examine the various relationships that directors may have with other business and non-profit organizations and management. As a result, we believe that the Proposed Rules

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could result in extensive disclosures that are less useful to investors than the current disclosures regarding categorical independence standards. As noted in the Commentary to NYSE Listed Company Manual Section 303A.02(a), the approach with respect to categorical standards described above "provides investors with an adequate means of assessing the quality of a board's independence and its independence determinations while avoiding excessive disclosure of immaterial relationships."

The Proposed Rules may also make it more difficult to recruit independent directors since companies will need to disclose mere coincidental relationships that do not impact a determination that a candidate is independent. Moreover, since the NYSE independence standards were adopted in 2003, we believe that investors have become accustomed to these disclosures about company categorical standards and independence determinations that fall outside of those standards. For these reasons, we believe that the Commission should revise Item 407(a)(3) to incorporate the categorical standards concept in Section 303A of the NYSE Listed Company Manual or the five percent threshold in current Item 404(b) so that immaterial transactions need not be disclosed.

We also are concerned that some of the required disclosures in proposed Item 407(e) concerning the compensation committee are not useful to investors and reflect a misunderstanding of the process followed by compensation committees in considering executive compensation. Specifically, the Proposed Rules will require disclosure of "any role of executive officers in determining or recommending the amount or form of executive and director compensation. "Company executive officers often provide information to the compensation committee that is necessary for the committee's decision making. For example, chief executive officers share their views on the individual performance of other executive officers, chief financial officers share financial information relevant to benchmarking performance and related compensation, the head of human resources may provide feedback on the company's compensation programs, and the general counsel may provide analysis with respect to the provisions of various equity-based plans. For these reasons, we urge the Commission to narrow the scope of proposed Item 407(e) so that it does not require disclosure of information sharing activities that are part of the ordinary procedures of information gathering used by compensation committees in considering executive officers' compensation.

#### **IX. Other Issues**

The Proposed Rules will significantly expand disclosures regarding severance and "change of control" payments. Pending before the Commission is a proposed rule to establish new NASD Rule 2290 (Amendment No. 3 to SR-NASD-2005-080, "Proposed Rule Change to Establish New NASD Rule 2290 Regarding Fairness Opinions"). This NASD proposal will require fairness opinions issued by NASD members to address whether executive compensation arising from the underlying transaction is a factor in reaching a fairness determination. Some NASD members have objected to the NASD proposal because they do not have the requisite expertise or experience with executive compensation arrangements generally to provide such analysis. We believe that the enhanced disclosures set forth in the Proposed Rules provides investors with necessary information about severance and change of control payments, thereby eliminating the need for the NASD proposal to address such issues.

\* \* \*

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Business Roundtable appreciates the opportunity to provide comments on the Proposed Rules. Please do not hesitate to contact Thomas Lehner at Business Roundtable at (202) 872-1260 if we can provide further information.

Sincerely,

/s/ Steve Odland

Steve Odland  
Chairman and CEO, Office Depot, Inc.  
Chairman, Corporate Governance Task Force  
Business Roundtable

Attachment

cc: Hon. Christopher Cox, Chairman, U.S. Securities and Exchange Commission  
Hon. Paul S. Atkins, Commissioner  
Hon. Roel C. Campos, Commissioner  
Hon. Cynthia A. Glassman, Commissioner  
Hon. Annette L. Nazareth, Commissioner  
John W. White, Director, Division of Corporation Finance  
Brian G. Cartwright, General Counsel

## EXHIBIT A

REVISED SUMMARY COMPENSATION TABLE

<u>Name and Principal Position</u> (a)	<u>Year</u> (b)	<u>Salary</u> (c) (S)	<u>Bonus</u> (d) (S)	<u>Stock Awards</u> (e) (S)	<u>Option Awards</u> (f) (S)	<u>Non-Stock Incentive Plan Compensation</u> (g) (S)	<u>All Other Compensation</u> (h) (S)	<u>Actually Received*</u> (i) (S)	<u>Total Compensation</u> <u>Opportunity to Earn** (S)</u>
Principal Executive Officer	____ ____ ____ ____								(i)
Principal Financial Officer	____ ____ ____ ____								
A	____ ____ ____ ____								
B	____ ____ ____ ____								
C	____ ____ ____ ____								

\* The Actually Received column, based on the Proposed Rules, generally would include the amounts in the columns titled Salary, Bonus, Non-Stock Incentive Plan Compensation and All Other Compensation.

\*\* The Opportunity to Earn column, based on the Proposed Rules, generally would include Stock Awards and Option Awards.

**MERCER MEDIAN CEO PAY TREND DATA**  
(\$000)

	1995	2005	CAGR
<i>Mercer 350 Median CEO Pay (\$000)</i>			
1. Salary	\$729.0	\$975.0	3.0%
2. Bonus <sup>1</sup>	703.0	1,433.7	7.4%
3. Long-Term <sup>1</sup>	1,287.5	4,421.5	13.1%
4. Total	\$2,719.5	\$6,830.2	9.6%
<i>Mercer 350 Median Financial Metrics (\$mil)</i>			
1. Revenue	\$5,055.7	\$7,627.5	4.2%
2. Net Income	261.5	590.5	8.5%
3. Market Cap	4,324.6	10,078.4	8.8%
4. TSR Index	1.00	3.32	12.7%

<sup>1</sup> Derived median

**The New York Times**

## A Contrarian Look at Whether U.S. Chief Executives Are Overpaid

By Tyler Cowen

The New York Times

05/18/2006

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FROM 1980 to 2003, the average compensation of an American chief executive at a top 500 company rose by a factor of about six. The average compensation for the chief executives of these top companies reached roughly \$11 million a year, including the value of options. No other country pays so much. For instance, American chief executives received roughly four times what their Swedish counterparts in comparably sized companies did and 3.1 times that of a Japanese chief at a comparably sized company.

Not surprisingly, many people think the American executives are overpaid. Their salaries are set by corporate boards, often filled with insiders or friends. Salaries for the top executive are far from transparent, especially when stock options and complex compensation plans are used. Nor is pay always linked to performance. Kenneth L. Lay received a salary and bonus of more than \$8 million plus perks in 2000, less than a year before Enron's collapse.

But in a new paper, "Why Has C.E.O. Pay Increased So Much?" ( <http://ssrn.com/abstract=901826> ), the economists Xavier Gabaix of the Massachusetts Institute of Technology and Augustin Landier of the Stern School of Business at New York University offer a contrarian view. They suggest that the higher salaries for chief executives can largely be explained by increases in the value of the stock market. Viewed as a whole, these salaries are a result of competitive pressures rather than the exploitation of shareholders.

Their core argument is simple. If we look at recent history, compensation for executives has risen with the market capitalization of the largest companies. For instance, from 1980 to 2003, the average value of the top 500 companies rose by a factor of six. Two commonly used indexes of chief executive compensation show close to a proportional sixfold matching increase (the correlation coefficients are 0.93 and 0.97, respectively; 1.0 would be a perfect match).

So how does this argument work? Better executive decisions create more economic value. If the number of big companies is greater than the number of good chief executives, competitive bidding will push up pay to reflect the value of the talent.

As Professors Gabaix and Landier predict, chief executives' salaries in different sectors are higher when the capitalization of that sector is higher. A stronger sector means more bidders for a chief executive of a particular kind; an executive who has run one car company can go run another. Chief executives in large industries, therefore, receive more, even after adjusting for the size of their current companies. Business services, computers and banking turn up as exceptions for this comparison; their top executives are overpaid relative to what market capitalization alone would imply. Perhaps chief executives can add more value in more dynamic sectors.

The authors are still working on their international comparisons; it is difficult to compare compensation across countries. But the preliminary results suggest that the total value of the companies in the sector helps predict how chief executives' salaries vary from country to country. Executives of large companies in France have fewer outside opportunities in comparable companies than their American counterparts and they thus receive less compensation, in this case by a factor of 2.4 to 1.

The approach of Professors Gabaix and Landier to executive compensation is influenced by their French background. In the United States, the popular debate turns on merit -- whether chief executives are worth the money. In Europe, where inequality is less socially acceptable, the popular debate concerns whether anyone could possibly deserve so much money. This perspective led Professors Gabaix and Landier to focus on explaining the overall level of executive compensation, opening up a new approach to the problem.

The two also find that the best chief executives do not seem to have much more talent than other chief executives in what they define as the top 250. By their calculations, replacing the No. 250 chief executive with the No. 1 will increase the value of the company by only 0.014 percent. The No. 1 chief executive receives much more compensation, but that is mostly because he manages a larger company and thus his talent has a longer reach. That is another way of thinking about why the same chief executive will make more money in a larger marketplace or in a larger country.

The Gabaix-Landier argument does not cover all objections. We do not have adequate data for longer stretches of American history. There are important cultural differences across countries. Lucian A. Bebchuk of Harvard Law School, a leading critic of chief executives' pay, argues in response to the paper that pay remains insensitive to performance, that high executive pay is correlated with bad corporate governance and that

chief executives take great care to hide their true compensation. For those reasons, he does not believe that executive pay is driven by productivity.

In any case, the debate over chief executives' salaries has moved a step forward. Yes, there are numerous examples of corporate malfeasance. But it is not obvious that the American system of executive pay -- taken as a whole -- is excessive or broken. The critics contend that chief executives cheat public shareholders. But private equity typically pays its top executives very well, even though public shareholders are not a factor. Furthermore, the rate of productivity growth in the United States has been the envy of the world. Chief executives must be doing something right.

The growth in executive compensation reflects how much more is at stake in American companies. Is not the real question which policies and institutions have led to this explosion of value?

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The Washington Post  
 washingtonpost.com

## Job Security Wanes in Executive Suites; CEO Turnover at Top Companies Was 15.3% in 2005, Highest in a Decade

Brooke A. Masters  
 The Washington Post  
 05/18/2006

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It's getting shaky at the top.

More than 15 percent of the world's 2,500 biggest companies lost their chief executives last year, and only half of the departures were voluntary, according to a study that will be released by the consulting firm Booz Allen & Hamilton today.

The number of chief executives who left -- 383 -- was up slightly from last year and the 15.3 percent turnover rate was the highest recorded in the 10 years Booz Allen has studied the matter. Turnover was highest in Japan, with 19 percent, and in North America, where the 16.2 percent turnover rate was the highest since 2000.

"We think this level of turnover is here to stay," said Paul Kocourek, a Booz Allen senior vice president and an author of the study. "Boards are much more activist, and they are not going to tolerate poor performance. . . . If your [company is] performing at 2.5 percent below the Standard & Poor's 500 index, you are at risk."

The statistics from North America tend to bear that out. Thirty-five percent of chief executives who departed in 2005 were forced out -- the most ever recorded in the survey -- compared with 44 percent who left voluntarily and 25 percent who lost their jobs because of mergers. Among the high-profile departures last year were Harry C. Stonecipher, forced out at Boeing Co. after a scandal; Hewlett-Packard Co.'s Carly Fiorina; Walt Disney Co.'s Michael D. Eisner, and Morgan Stanley's Philip J. Purcell.

Retirements and other voluntary departures have not changed significantly since 1995, but the number of chief executives forced out for performance-related reasons has more than quadrupled, Kocourek said.

Much of the change seems to stem from regulatory changes that have emphasized director independence and made them feel more personally responsible for company performance, as well as the growing willingness of large investors to challenge company strategies when share prices are lagging.

High chief-executive turnover can have both good and bad consequences.

"It's very good. It creates a culture of accountability," said Charles M. Elson, who directs the Center for Corporate Responsibility at the University of Delaware. "Boards who remove CEOs are to be congratulated. They're doing their job. . . . In the old days, there were lots of reasons to remove [corporate leaders], but boards dominated by CEOs didn't do it."

For employees, change can create uncertainty. "CEO turnover is often coupled with broader organizational change along the lines of layoffs and selling businesses and changing strategies," said Paul Oyer, an associate professor of economics at Stanford University's business school. "When CEOs turn over, that's both a problem and an opportunity."

On the other hand, high turnover could make chief-executive jobs less attractive. "If you ask CEOs to take the risk of having to resign in a fairly public manner . . . people might be less willing to take the job and want higher compensation, which means you shrink the pool," said Constance E. Helfat, a strategy professor at Dartmouth's Tuck School of Business who studies chief-executive turnover.

Some analysts wondered whether the problem will be exacerbated if the Securities and Exchange Commission adopts a proposal to require more disclosure of executive perks. If it does, they said, top business executives might decide to work for a privately held company or a venture capital firm rather than a publicly traded firm, to avoid the risk of public scrutiny.

The Booz Allen study also looked at the succession process and concluded that over the short term, companies that brought in new chief executives from the outside did better than those that promoted someone from the inside. But insider chiefs tended to serve longer and provided better shareholder return over the long haul.

Others who have studied the matter said the Booz Allen study may overstate the benefits of outsiders, even in the short term, because outsiders are more likely to inherit companies that are in bad shape where investors are primed to respond positively to any kind of change. Helfat said that in her study of chief executives during the first three years of their tenure, she found that once she adjusted for the company's previous performance, outsiders and insiders performed, on average, equally well. Outsider chiefs were more of a gamble, she said, because

they were more likely to do spectacularly badly or spectacularly well, while insiders tended to stick closer to average.

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THURSDAY, SEPTEMBER 8, 2005

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## REVIEW & OUTLOOK

### Private FEMA

In time we'll find out what went wrong after Katrina hit, but it's not too early to start drawing attention to what went right. Near the top of any list should be the remarkable response of the business community. It's had a lot to do with the relief effort's successes.

The straightforward generosity of the corporate sector has been well reported. By last count, donations had exceeded \$200 million. Besides cash, companies have handed out free drugs, suspended finance payments on cars and mortgages and helped emergency personnel with equipment. As interesting, though, has been the application of corporate best practices—from supply-chain management to logistics—to a natural disaster.

The private-sector planning began before Katrina hit. Home Depot's "war room" had transferred high-demand items—generators, flashlights, batteries and lumber—to distribution areas surrounding the strike area. Phone companies readied mobile cell towers and sent in generators and fuel. Insurers flew in special teams and set up hotlines to process claims.

This planning allowed the firms to resume serving customers in record time. Katrina shut down 126 Wal-Mart facilities; all but 14 are now open. Entergy, the power company for 1.1 million households and businesses that lost electricity, had restored electricity by Monday to 575,000 customers, including areas of flooded New Orleans.

Businesses offered near-instant support to their own employee-victims. Staff

set up hotlines and began tracking down missing workers. Thousands of workplace victims were provided with places to stay, promises of continued pay and even offers of replacement jobs elsewhere in the country.

At the heart of the corporate response was a stunning array of advanced communications networks that kept firms in touch and coordinating. Following on last year's tsunami aid effort, the Business Roundtable had by August of this year arranged for each of its 160 member companies to designate a disaster relief point man. These folks were in place and ready to help before Katrina made landfall. The U.S. Chamber of Commerce, through its non-profit Center for Corporate Citizenship, became a clearinghouse, fielding calls from many of its 3,000 state and local organizations and compiling lists of needed supplies.

By the weekend the Chamber's CCC was turbo-charging a new computer program, designed by tech firm i2, which served as a kind of bridal registry for needed relief supplies. Each donor company indicated what order it would fill, avoiding duplication or delay. IBM got to work on a computerized job bank to help place those who'd lost work. The American Trucking Association set up a Web site to update everyone on road conditions.

Companies then focused on doing what each did best. In some cases it was simply ramping up operations, as with Black & Decker, whose employees worked Labor Day weekend to churn out extra

generators. In other cases, it was firms using their modern logistical skills to get into hard hit areas. FedEx and other delivery companies used computer systems with designed-in flexibility to reroute vehicles and adjust flights to get in aid. FedEx has already moved more than 100 tons of relief supplies.

Wal-Mart mined its vast databases of past purchases to compile lists of goods most desired after a hurricane. (Among the top items? Strawberry pop tarts.) Because of its advance logistics planning, the big retail chain was able to quickly move in to devastated areas with mini Wal-Marts to hand out goods. Other firms leveraged similar supply-chain capabilities; Pfizer dispensed pharmaceuticals via Wal-Mart and other retailers. "What companies do is solve problems," says Johanna Schneider, an executive director at the Business Roundtable.

Granted, a FEMA is never going to operate with the agility of a FedEx. FedEx and the others perform at this level 24/7; that's the nature of competition. That said, surely there are lessons here worth learning and attempting to transfer to the public sector. And we don't mean three years from now after another round of reassessment and performance reviews. The challenge of reconstruction is now. It wouldn't hurt if the responsible public agencies asked the private participants in the rescue operation for some pointers on getting the next job done on budget and on time.

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**DOW JONES**

United States House of Representatives  
Committee on Financial Services

Testimony of Nell Minow  
Editor, The Corporate Library  
May 25, 2006

Thank you very much for inviting me to appear today. I am very pleased that this committee is looking into this vital area of concern and considering a proposal I endorse with enthusiasm.

The economist John Kenneth Galbraith said, "The salary of the chief executive of the large corporation is not a market award for achievement. It is frequently in the nature of a warm personal gesture by the individual to himself."

He said that in the 1950's. The primary change since then is the number of zeroes at the end of the figures.

My firm, The Corporate Library, maintains an extensive database on corporate governance in public companies, and that includes a great deal of information and analysis of executive compensation. The data show that the disparity between pay and performance is enormous and growing.

The Corporate Library recently conducted a special study, for its latest CEO compensation survey, that was designed to test whether the highest compensation increases in the S&P 500 reflected significant long-term improvements in company performance. The results of the study showed that the largest percentage increases in total compensation had very little connection to long-term value creation. This table shows the examples of the greatest disparity between pay and performance:

Company Name	Ticker	Fortune Rank	Current CEO	Total CEO compensation in last two fiscal years	TCL Rating	5-Year TSR	Performance vs. Peers
AT&T Inc.	T	33	Edward E. Whitacre	\$34,435,596	D	-40.32	Underperformed
BellSouth Corporation	BLS	67	F. Duane Ackerman	\$22,747,700	D	-26.33	Underperformed
Hewlett-Packard Company	HPQ	11	Mark V. Hurd	\$27,056,129	D	-9.88	Underperformed
Home Depot, Inc. (The)	HD	13	Robert L. Nardelli	\$50,717,002	F	-19.05	Underperformed
Lucent Technologies Inc.	LU	247	Patrick F. Russo	\$17,317,113	F	-82.05	Underperformed
Merck & Co., Inc.	MRK	84	Richard T. Clark	\$40,754,311	D	-49.80	Underperformed
Pfizer Inc.	PFE	24	Henry A. McKinnell	\$26,365,439	D	-34.11	Underperformed
Safeway Inc.	SWY	46	Steven A. Burd	\$33,510,855	D	-54.99	Underperformed
Time Warner Inc.	TWX	32	Richard D. Parsons	\$26,058,130	D	-57.71	Underperformed
Verizon Communications Inc.	VZ	14	Ivan G. Seidenberg	\$26,580,200	D	-26.83	Underperformed
Wal-Mart Stores, Inc.	WMT	1	H. Lee Scott	\$27,961,065	D	-13.90	Underperformed

It's a very small group in the stratosphere of pay: rock stars, movie stars, athletes, investment bankers, and CEOs. Of that group, the first four are in the ultimate pay-for-performance category, with a tiny percentage at the very top making millions of dollars, and with deals that evaporate quickly if a movie, a CD, or a business deal tanks. Their pay is set through tough arms-length negotiations.

CEOs are the only ones who pick the people who set their pay, indeed they pay the people who set their pay. And no matter what "independence" standard we try to impose, the board room culture of congeniality and consensus is so powerful that it makes it very hard to object, especially when the compensation consultant helpfully provides an avalanche of numbers designed to justify pay increases. In the wonderful world of CEOs, like the children in Lake Woebegon, everyone is above average. Even Warren Buffett acknowledges his own failings as a director, particularly in approving excessive compensation: "Too often, collegiality trumped independence." If Warren Buffett, always a significant shareholder in any company on whose board he serves, does not feel able to oppose excessive pay, something is wrong.

In the 1990s, the cult of the CEO was based on the idea that vision and the ability to inspire were what made the CEOs worth the hundreds of millions of dollars they were paid. But a book by Harvard Business School professor Rakesh Khurana, *Searching for a Corporate Savior: The Irrational Quest for Charismatic CEOs*, makes a compelling case that corporate boards err seriously when they pick chief executives based on "leadership" and "vision" or when they pay huge premium pay that is not sensitive to performance to attract a "superstar." Bringing in a CEO with a great record at another company may give the stock price a short-term boost. But high-profile transplants such as Al Dunlap at Sunbeam (which went into bankruptcy) and Gary Wendt at Consec (which went into bankruptcy), CEOs should have to make the same disclaimers that money managers do: "Past performance is no guarantee of future performance."

Disclosure is important. The SEC's proposed rules are a step in the right direction. But disclosure only matters if the people who absorb this information have the ability to act on it, and that is not currently the case. Executive compensation is a hydra-headed monster – every attempt to cut off one-head results in the growth of two more. Current abuses include these seven deadly sins of executive compensation:

1. Accelerated vesting of options
2. Manipulation of earnings to support bonuses
3. Imputed years of service
4. Setting the bar too low (guaranteed bonus)
5. Outrageous departure and retirement packages
6. Stock options that are not performance-based (including back-dating)
7. Perquisites and gross-ups

Until we remove the impediments to a market response from shareholders, we will never be able to address these problems.

I leave you with two key points. First, executive compensation must be looked at like any other allocation of corporate assets. Currently, the ROI for executive pay does not measure up to just about any other use of corporate capital.

Second, the pay-performance disparity is so outrageous, so atrocious that in my opinion it undermines the credibility of our system of capitalism. In a global environment, information and the ability to trade in any market at any time will provide our system with the toughest market test in the history of our country. As we compete for capital, we must be able to show those inside and outside our country that we deserve their trust and will provide them with a competitive return instead of shoveling more money into the pockets of the top executives.

Many thanks, and I will be glad to answer any questions.

**TESTIMONY OF BRANDON J. REES**  
**ASSISTANT DIRECTOR, OFFICE OF INVESTMENT**  
**AMERICAN FEDERATION OF LABOR AND**  
**CONGRESS OF INDUSTRIAL ORGANIZATIONS**  
**Before the**  
**COMMITTEE ON FINANCIAL SERVICES**  
**UNITED STATES HOUSE OF REPRESENTATIVES**  
**MAY 25, 2006**

Good afternoon, Mr. Chairman Oxley and Ranking Member Frank, my name is Brandon Rees. I am the Assistant Director of the Office of Investment for the American Federation of Labor and Congress of Industrial Organizations (AFL-CIO). I am honored for the opportunity to participate in today's hearing on the agenda of the Securities and Exchange Commission. The AFL-CIO believes H.R. 4291, the Protection Against Executive Compensation Abuse Act, is essential to reform CEO pay.

The first problem with executive compensation is that CEOs are being paid too much relative to their individual contribution to their companies. No CEO is so talented that his or her compensation should be unlimited. Secondly, executive compensation is poorly disclosed to shareholders. Many forms of CEO pay such as pensions and perks are underreported, and CEO pay-for-performance targets are hidden from shareholders. Thirdly, today's executive compensation packages are creating improper incentives for executives. For example, stock options can create a strong incentive to manipulate company stock prices through creative and even fraudulent accounting.

By any measure, today's CEO pay levels are too high. A reasonable and fair compensation system for executives and workers is fundamental to the creation of long-term corporate value. However, the past two decades have seen an unprecedented growth in compensation only for top executives and a dramatic increase in the ratio between the compensation of executives and their employees. Today, the average CEO of a major U.S. company makes 431 times the average worker's pay, up from 42 times in 1980. This ten-fold increase in CEO pay is not sustainable, and is a prime cause of growing economic inequality.

Executive compensation abuse takes dollars out of the pockets of shareholders, including the retirement savings of America's working families. Union members participate in pension plans with over \$5 trillion in assets. Union-sponsored pension plans hold approximately \$400 billion in assets, and runaway executive pay has diminished returns for working families' pension funds. Moreover, a poorly designed executive compensation package can reward decisions that are not in the long-term interests of a company, its shareholders and employees.

Earlier this year, the Securities and Exchange Commission proposed new rules on executive compensation and related party disclosure (SEC File Number S7-03-06). The Commission and its staff should be commended for recognizing that excessive executive compensation has become a major corporate governance problem. The SEC's proposed



changes are the first major update of its executive compensation disclosure rules in over 14 years, and they will go a long way to improve the current regulation. While the AFL-CIO strongly supports the SEC's efforts to increase transparency and clarity in executive compensation disclosure, we believe the final rule should be made stronger. Companies should be required to disclose their executives' pay-for-performance targets, and every director's potential conflicts of interest.

More than any other executive compensation issue, shareholders are concerned about pay-for-performance. Year after year, shareholders learn of record CEO compensation packages that have little connection to executives' individual performance. Company proxy statements routinely provide only the most generic boilerplate descriptions about how CEO pay is established. To public shareholders, the executive compensation system appears entirely subjective and subject to influence by corporate insiders.

Shareholders should be told what performance targets are being established for senior executives, whether executives meet their performance targets, and what levels of compensation are tied to the performance targets. Without the disclosure of the quantitative performance targets, shareholders have no ability to evaluate a company's executive compensation strategy. While disclosure of performance targets will not guarantee pay-for-performance, at least shareholders will be able to have an informed dialogue with compensation committee directors about appropriate pay practices.

Under the SEC's proposed disclosure rules, companies are not required to disclose pay-for-performance target levels if companies consider that information to be competitive or proprietary in nature. This disclosure loophole is not justified, and the SEC should require the disclosure of pay-for-performance targets. The performance benchmarks for senior level executives are generally based on disclosed financials. At a minimum, disclosure could be made retroactively after the conclusion of the performance period.

The SEC has also proposed to loosen the disclosure threshold for directors' related party transactions from \$60,000 to \$120,000. This weakening of the disclosure standards for directors' potential conflicts of interest flies in the face of recent regulatory trends on director independence. Director independence is critical for an objective executive compensation process, and the absence of independent directors is a root cause of runaway CEO pay. For these reasons, we strongly oppose the SEC's proposed increase of the related party transaction disclosure threshold.

The AFL-CIO believes that shareholders should have a right to know their executives' pay-for-performance targets. Shareholders should also be told if their directors have potential conflicts of interest. We believe that the investing public shares our view. Using the AFL-CIO's Executive Paywatch website [www.paywatch.org](http://www.paywatch.org), approximately 20,000 individuals have commented on the SEC's proposed rulemaking – one of the highest totals in the 72-year history of the SEC, according to SEC Chairman Christopher Cox's April 25, 2006 testimony before the Senate Banking Subcommittee.

Under the current rules, many forms of executive pay are hidden from shareholders. For example, Harvard Law Professor Lucian Bebchuk has estimated that retirement benefits make up one-third of a typical CEO's total compensation. Yet the current proxy rules provide poor disclosure of executive retirement benefits. Because these benefits have been obscured, many shareholders have not paid attention to their growth. Shareholders shouldn't need the help of a Harvard law professor or an expert compensation consultant to decipher what retirement benefits have been promised to their CEO.

This poor disclosure has led to outrageous CEO golden retirements. Many CEOs have negotiated retirement benefits that promise a lifetime of income far exceeding what they would be entitled to under the retirement plans of their rank-and-file workers. The promise of a virtually guaranteed multi-million dollar annual pension—no matter what happens to the company or its stock price—dramatically undermines the goal of linking CEO pay to performance. Often times, companies sweeten their executives' retirement benefits with preferential terms such as unearned years of service credit or above-market interest rates that are guaranteed by the company.

Executives have received these extraordinary retirement benefits at the same time workers are being asked to bear increased risk for their retirement security. According to the U.S. Bureau of Labor Statistics, fewer than half of all workers receive any retirement benefits from their employers. Only 21 percent of private-sector employees are covered by defined benefit pension plans, and only 42 percent have defined contribution 401(k) plans. In contrast, a 2005 survey by Clark Consulting found that 69 percent of Fortune 1,000 companies offer Supplemental Executive Retirement Plans, and 91 percent offer Nonqualified Deferred Compensation Plans for senior executives.

Every American deserves a secure retirement. Yet increasingly, companies are terminating their employees' pension plans and transferring the risk of saving for retirement onto their employees. At the same time, many of these same companies have turned their executive pension plans into CEO wealth creation devices. As a result, many companies have a two-tier retirement system: one for the CEO and one for everybody else. The irony is that these preferential executive retirement benefits are also hurting the retirement savings of America's working families by undermining the goal of linking CEO pay to performance and by creating unfunded liabilities for shareholders.

Working with the Corporate Library, the AFL-CIO's Executive Paywatch website [www.paywatch.org](http://www.paywatch.org) has identified many of the largest CEO pensions. Leading the list is Exxon Mobil CEO Lee Raymond who accrued an annual pension of over \$8 million. On his retirement on January 14<sup>th</sup>, 2006, he opted for a lump-sum cash payment of \$98 million. Meanwhile, *Business Week* has reported that out of all U.S. corporations, Exxon Mobil's employee pension plans have the biggest funding deficit of \$11.2 billion ("Shortfall At Exxon: All Those Profits – But Underfunded Pensions," May 29, 2006).

Other CEOs' super pensions are equally disturbing. At Pfizer, CEO Henry McKinnell will receive an annual pension of \$6.5 million or a lump sum of over \$83 million. Meanwhile, Pfizer's stock price has fallen nearly 50 percent under his leadership as CEO.

Or consider UnitedHealth Group CEO William McGuire, who will receive over \$5 million a year in pension benefits. That is on top of his \$1.75 billion in accrued stock options, many of which were improperly backdated to maximize their value. IBM CEO Samuel Palmisano's pension is worth \$4.5 million annually despite IBM's recent announced pension freeze. Home Depot CEO Robert Nardelli will get \$4.6 million each year in retirement while his employees don't even have a defined benefit pension plan.

The Protection Against Executive Compensation Abuse Act and the SEC's proposed rulemaking on executive compensation disclosure will go a long way to expose these preferential executive retirement benefits. Both this bill and the Commission's proposed rulemaking will require companies to provide a dollar estimate of their executives' accrued pension benefits. They will also introduce many other needed reforms, including improved disclosure of executives' perks and golden parachutes, as well as require that companies disclose their executives' compensation in clear and simple language.

While the SEC's proposed disclosure improvements are important, more should be done. H.R. 4291 will require companies to disclose short and long term pay-for-performance targets. This type of pay-for-performance disclosure is critical to encouraging responsible executive compensation practices. Under H.R. 4291, companies also would be required to claw-back executive compensation that is awarded based on inaccurate results in the event of an accounting restatement. CEO pay that is based on financial results that are later restated downwards constitutes undeserved compensation and should be returned.

H.R. 4291 will amend the Securities and Exchange Act of 1934 to require shareholder approval of executive compensation plans. H.R. 4291 would also require that all companies submit their golden parachutes to a separate shareholder vote in the event of a change in control. Requiring shareholder approval of executive compensation plans is an important safeguard. In the United Kingdom and Australia, shareholders routinely vote on CEO pay packages. Today at the Home Depot annual meeting, shareholders are voting on an innovative proposal by the American Federation of State, County and Municipal Employees (AFSCME) to require an advisory vote on CEO pay.

While improved CEO pay disclosure is a necessary reform, disclosure alone will not be sufficient to end executive compensation abuses. Excessive CEO pay is fundamentally a corporate governance problem. When CEOs wield too much power in the boardroom, they are able to extract economic rents from shareholders—the CEO equivalent of monopoly profits. These rents are known as agency costs, and arise from the separation of ownership and control. The board of directors is supposed to protect shareholder interests and minimize these agency costs.

Excessive executive compensation is a red flag that there is a power imbalance in the corporate boardroom. At approximately two-thirds of U.S. companies, the CEO is the board's chair. When one single person serves as both chair and CEO, it is impossible for that person to objectively monitor and evaluate his or her own performance. Requiring that boards be chaired by independent directors will enhance the objective leadership of the board and result in a more balanced executive pay process. Ultimately, shareholders

have to be able to trust their boards of directors to provide vigorous oversight of CEOs and to set responsible CEO pay packages.

For this reason, CEO pay will be reformed only when corporate boards are made more accountable. Not surprisingly, many boards and their compensation committees are comprised of directors who are overpaid CEOs in their own right. Other directors have business or personal relationships with the company and its CEO that make them "too close for comfort." The vast majority of director nominees are also hand-picked by the incumbent board with the tacit consent of the CEO. Under the proxy rules, it is cost prohibitive for shareholders to run their own director candidates.

To break this self-perpetuating system, shareholders must have greater voice in the election of directors. Under the plurality vote system at most companies, a director can be elected to a board even if a majority of shareholders withhold support from that director. This year, union-sponsored pension funds have filed over 150 shareholder proposals urging that directors be elected by majority vote. The AFL-CIO also strongly urges the SEC to give shareholders equal access to the proxy. Until then, CEOs will continue to influence the size of their own compensation, and CEO pay will continue to rise.

**Written Testimony  
Prepared for the U.S. House Financial Services Committee**

**May 25, 2006**

**By  
Christianna Wood  
Senior Investor Officer  
Global Public Equity  
California Public Employees' Retirement System**

Chairman Oxley, Congressman Frank, and members of the Committee, I am pleased to provide the perspective of an institutional investor on the issue of executive compensation and its related legislation.

I am Christianna Wood, Senior Investment Officer for Global Equity, with the California Public Employees' Retirement System (CalPERS). CalPERS is the nation's largest public pension system with more than \$200 billion in assets. We have long been a leading voice in Corporate Governance, and an advocate for better alignment of interests between shareowners and management.

Compensation programs are one of the most powerful tools available to companies to attract, retain and motivate key employees, as well as align their interests with those of shareowners. Poorly designed compensation packages may have disastrous impacts on a company and its shareowners by nurturing short-term, self-interested behavior. Conversely, well-designed compensation packages may help align management with owners and drive long-term superior performance.

Since equity owners have a strong interest in long-term performance and are the party whose interests are diluted by equity compensation plans, CalPERS believes shareowners should seek stronger oversight of executive compensation programs.

If I had to identify one issue that is at the heart of the problem with compensation in the United States, I would point to accountability. More appropriately perhaps to a lack of accountability. This is an area where we can make reform with the support of the Congress.

Therefore, we support legislation that would help investors and shareowners identify how their capital is being used. We want disclosure and communication about executive pay packages in simple English. We want pay clearly tied to performance, demonstrated in simple math with clearly defined measures of success and failure. Too often, we are paying not for performance, but for failure.

### **Executive Compensation Abuses**

Something has gone wrong with executive compensation in the United States. It is disturbing to see example after example of top executives insulating themselves from any risk in their own compensation. They are ensuring their own financial security while shareowners are losing value.

There are countless examples of questionable executive compensation practices. Let me cite a few of them here.

Just this month, CalPERS asked other Home Depot shareowners to join us in supporting a resolution that would require the company to seek a non-binding investor vote on its executive pay plan. In part, this was in response to reports that Home Depot awarded its chief executive substantial pay raises in recent years despite a decline in the company's stock. Home Depot awarded Robert Nardelli more than \$190 million over the past five years, while over the same period, the company's total stock return declined by 12 percent.<sup>1</sup> By comparison, the total stock return for Lowe's, Home Depot's chief rival, increased by 140 percent, and the industry as a whole experienced a 2 percent gain over the same five years.

Secondly, in March, large shareowners sued Hewlett-Packard to contest a \$21.4 million severance package for former chief executive Carleton Fiorina, who was replaced last year after lagging company performance. The lawsuit said her severance package of \$21.4 million was 3.75 times her salary and bonus of \$5.6 million, and that it could be worth up to \$42 million after factoring in the potential value of her stock and options.<sup>2</sup>

Third, Boeing's former chief executive received almost \$11.5 million in salary and stock awards after working less than three months for the company before he was ousted. In three months, he couldn't have made much of a difference in the company's performance.<sup>3</sup>

These examples reflect an unfortunate national disconnect between pay and performance. They are just a few of the examples that reflect on how poorly designed compensation policies and packages can have negative impacts on a company and its owners – shareowners.

Nationwide, the median salary and bonus for chief executives in 2005 increased 7.1 percent to \$2.4 million, according to a survey by Mercer Human Resource Consulting for the Wall Street Journal. That increase in cash compensation came after a record compensation increase of 14.5 percent the previous year.<sup>4</sup> Yet, it is not the absolute increase that is most troubling. It is the lack of clarity on how increased executive compensation is aligned with increased shareowner value creation.

Let me be very clear: CalPERS does not believe that it is appropriate for shareowners to approve individual contracts at the company specific level. However, CalPERS does believe that companies should formulate executive compensation policies that tie executive compensation to company performance and then seek shareowner approval for those policies on a periodic basis.

Executive compensation programs should be designed and implemented to ensure alignment of interest with the long-term interests of shareowners. Without the appropriate controls being in place, such as improved transparency, compensation schemes may give executives an incentive to avoid their duty to shareowners. For example, because senior executives often receive additional compensation when they acquire a new company or sell their current one, there is a conflict of interest between the executives' interest and the company's interest.

Defenders of soaring executive compensation attribute the trend to marketplace dynamics. They say it is in the interest of investors to award such compensation in a market where executive pay only matches the soaring value of top companies.

Yet that parallel fails to account for the widening pay gap between executives and ordinary employees and egregious compensation for executives whose companies lost money. Moreover, if executive pay were truly driven by productivity, there would be no need for the shell games that companies play to hide compensation.

While the absolute levels of pay are a concern, perhaps the most troubling element of executive compensation is the "Heads I win, tails you lose" attitude of corporate executives. CalPERS is concerned over what appears to be an attitude of entitlement in the executive suite of corporate America, regardless of the success – or lack thereof – of the corporation. This attitude manifests itself in many forms.

Perhaps some of the more offensive entitlements are the so called forms of "stealth compensation": severance packages complete with perks for life, guaranteed pension benefits far outstripping the value of benefits provided to employees, enormous loans to executives that are eventually forgiven, and provisions providing that the company shall pay all the taxes due (including gross-up provisions) should the executive incur a tax liability all send a clear message to shareowners.

The message is: "We do not respect you as owners. We do not feel accountable to you as owners."

As public markets investors, we rely upon boards of directors to represent us. In the case of compensation, a company's Compensation Committee is charged

with representing shareowners. A major contributing factor to the problem with executive compensation is that Compensation Committees are not accountable to shareowners. They obviously do not feel that approving abusive compensation packages will cost them their job. Rather, it appears that not approving what the CEO wants is what they feel will cost them their job. This represents the central conflict of interest inherent in the problem of executive compensation today. Until this fundamental issue is solved, we will continue to have widespread abuse in compensation practices.

### **The Legislation**

We believe that Congressman Frank's legislation addresses this fundamental problem. We are not asking the government to set artificial limits on executive compensation, and this bill would not set such limits. Instead, we are asking for more information about management pay packages and the ability to restrain management abuse. This bill would do that.

The legislation would provide full disclosure of the compensation of top executives, including pensions, golden parachute agreements, the use of private jets and company apartments, and other compensation now hidden. It would require disclosure of short- and long-term performance targets used to determine a top executive's compensation, and whether such measures were met in the preceding year.

It would require companies to have a "clawback" policy for recapturing any form of incentive compensation that is unjustified, based on subsequent findings that the numbers used to calculate the awards were inaccurate, requiring restatement.

The bill also would require separate shareowner approval of golden parachute packages and the posting of clear and simple disclosures of compensation on the company's Web site.

### **Legislation Fits Investors' Corporate Governance Goals**

These provisions of "The Protection Against Executive Compensation Abuse Act" are well-aligned with CalPERS corporate governance principles.

CalPERS amended its U.S. Corporate Governance Core Principles and Guidelines recently to call on companies to formulate executive compensation policies and seek shareowner approval for those policies. Currently, Compensation Committees issue a statement in the proxy to briefly describe the company's compensation philosophy. Shareowners' role in this process presently is relegated to a distant back seat.



In discussions with companies about this issue, they often state emphatically that only the board has the right and the expertise to manage the affairs of the company and particularly the issue of compensation. Companies say the Compensation Committee must have the flexibility to attract and retain executives and that shareowners should essentially trust them to do the right thing. Yet the behavior of corporate America in regards to executive compensation indicates otherwise.

We believe it is a completely appropriate right of corporate owners to approve broad policies related to executive compensation. Perhaps most importantly, the exercise of that right would force Compensation Committees to face shareowners with a plan on how they will use compensation of all forms in optimizing managing of the corporation. This will help to shift the accountability back to where it belongs, to the owners.

Under current exchange rules, companies are not required in certain circumstances to obtain shareowner approval to adopt equity-based compensation plans. In other words, companies are allowed to unilaterally dilute the equity of owners of the corporation. It is ridiculous to think that an owner should not have the right to decide if he or she is willing to dilute their equity, no matter what the purpose. It is even more ironic when you consider the fact that boards and management have a significant self interest in adopting equity based compensation plans.

We believe executive compensation programs should be designed and implemented to ensure alignment of management's interest with the long-term interests of shareowners. Such programs should be comprised of a combination of cash and equity based compensation, and direct equity ownership should be encouraged.

We believe executive compensation policies should be transparent to shareowners. The policies should contain, at a minimum, compensation philosophy, the targeted mix of base compensation and "at risk" compensation, key methodologies for alignment of interest, and parameters for guidance of employment contract provisions, including severance packages.

Finally, companies should submit executive compensation policies to shareowners for approval, and executive contracts should be fully disclosed with adequate information to judge the "drivers" of incentive components of compensation packages.

Excessive CEO pay takes money out of the pocketbooks of shareowners, including the retirement savings of America's working families. Moreover, a poorly designed executive compensation package can reward decisions that are not in the long-term interests of a company, its shareowners and employees.

Pay decisions are one of the most direct ways for shareowners to assess the performance of the board.

To properly perform this assessment, shareowners must have comprehensive, accurate and clear information detailing long- and short-term compensation to executives. The Protection Against Executive Compensation Abuse Act would provide for full disclosure of information about all compensation paid to executives and the performance measures tied to compensation.

If enacted, the law would improve corporate governance in America which, as the research indicates, leads to better corporate performance. In a perfect world, we wouldn't need this law. The financial world isn't perfect, as our newspapers attest. We need the rule of law to help keep corporate America on course.

Thank you. I would be glad to answer any questions that you may have.

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<sup>1</sup> "Revolt Looms at Home Depot Over Executive Pay," Financial Times, May 18, 2006.

<sup>2</sup> "Pay Deal at Hewlett is Contested," New York Times, March 8, 2006.

<sup>3</sup> "Boeing's Ousted Chief Gets \$11.5 Million in '05," Los Angeles Times, March 8, 2006.

<sup>4</sup> CEO Compensation Survey," Wall Street Journal, April 10, 2006.

Testimony of Ann Yerger

Executive Director

Council of Institutional Investors

**Hearing of the Committee on Financial Services**

**Protecting Investors and Fostering Efficient Markets: A Review of the S.E.C. Agenda**

**May 25, 2006**

Chairman Oxley, Ranking Member Frank and members of the Committee, my name is Ann Yerger, and I am the Executive Director of the Council of Institutional Investors, an organization of more than 300 investment professionals, including more than 130 public, corporate and union employee benefit plans with more than \$3 trillion in investments. The Council, a leading advocate for improving corporate governance standards for U.S. companies and strengthening investor rights, appreciates the opportunity to discuss the agenda of the Securities and Exchange Commission, particularly the Commission's efforts regarding executive compensation issues.

Headlines in recent years have highlighted a host of executive compensation abuses at U.S. companies. Examples have included: lavish pay packages despite poor corporate performance or even, in some cases, corporate bankruptcies; outsized equity awards resulting in pay disproportionate to company performance; and poorly structured incentive programs creating pay-for-performance disconnects. Most recently articles have identified how executives at a growing list of U.S. companies have benefited by backdating stock option grants to take advantage of stock price lows.

These headlines highlight the reasons why executive compensation has long topped the list of corporate governance issues of concern to the Council and its members. Our concerns have centered not simply on the amount paid to CEOs and other top executives, but also the board processes for setting pay, the disclosure of pay, the structure of pay and the pay-for-performance metrics.

As long-term investors with a significant stake in the U.S. capital markets, Council members have a vested interest in ensuring that U.S. companies attract, retain and motivate the highest-performing employees and executives. They are supportive of paying top executives well for superior performance.

However, Council members and other investors are harmed when poorly structured executive pay packages waste shareowners' money, excessively dilute their ownership in portfolio companies and create inappropriate incentives that may reward poor performance or even damage a company's long-term performance. Inappropriate pay packages may also suggest a failure in the boardroom, since it is the job of the board of directors and the compensation committee to ensure that executive compensation programs are effective, reasonable and rational with respect to critical factors such as company performance and industry considerations.

The Council believes executive compensation issues are best addressed by requiring companies to provide full, plain English disclosure of key quantitative and qualitative elements of executive pay, by ensuring that corporate boards are held accountable for their executive pay decisions, by

giving shareowners meaningful oversight of executive pay and by requiring disgorgement of ill-gotten gains pocketed by executives. In general, the Council believes the regulatory bodies—the SEC and the stock exchanges—are best positioned to address shortfalls or problems with these checks and balances. The Council is very hopeful that the SEC’s current initiatives will address the important issues raised by Ranking Member Frank in H.R. 4291 “Protection Against Executive Compensation Abuse Act” and thus eliminate the need for legislation.

#### **Disclosure**

Of primary concern to the Council is full and clear disclosure of executive pay. As U.S. Supreme Court Justice Louis Brandeis noted, “sunlight is the best disinfectant.” Transparency of executive pay enables shareowners to evaluate the performance of the compensation committee and board in setting executive pay, to assess pay-for-performance links and to optimize their role of overseeing executive compensation through such means as proxy voting.

Current rules addressing the disclosure of executive pay are out of date and in need of significant improvement. The Council is very pleased the SEC recently proposed expansive updates to the current executive compensation disclosures and commends the Commission and its staff for preparing these rules, which we believe address a significant number of the most critical issues to investors.

The Council supports the SEC’s proposal. We believe the following disclosure elements are of critical importance:

Disclosure of all components of executive pay

The SEC proposal would require companies to provide complete disclosure of all elements of executive compensation. Such an approach is consistent with Council policy, which calls for clear, comprehensive and prompt disclosure, in plain English, of all aspects of executive pay, whether or not such disclosure is required by current rules and regulations.

Current disclosure rules are lacking. Because companies do not have to value or disclose key information regarding certain elements of compensation, shareowners have not had access to complete information about executive pay programs. As a result, shareowners and market forces have been unable to play an effective role in setting compensation parameters.

The Council realizes that disclosure of some components of executive pay—including a total compensation figure, the value of options and retirement benefits, and the potential value of severance agreements—necessarily involves estimates based on assumptions and valuation models. Some oppose these disclosures, arguing that valuation complexities make it impossible to fairly value these components and investors might not understand the disclosures. The Council disagrees. First, such calculations are necessary for compensation committees to fully understand major portions of compensation programs and the full value of executive pay packages. Second, such disclosure enables shareowners to analyze the compensation committee's decisions and to fully understand the compensation paid to top executives.

The Council notes that the SEC's proposal to require complete disclosure of any type of compensation paid, or to be paid, to an executive, including estimates of the value of pensions and contractual arrangements, is consistent with the disclosure provisions contained in H.R. 4291. The Council encourages the Committee on Financial Services and the SEC to work together to ensure the final disclosure rules provide full and complete disclosure of all forms of compensation.

Disclosure of performance-based pay

The Council believes executives should be rewarded for sustainable, superior long-term performance that is based predominantly on total stock returns and key operational measures. Council policies do not advocate arbitrary restrictions or caps on compensation. Rather, they emphasize the concept of pay-for-performance, including the full disclosure of qualitative and quantitative performance measures and benchmarks used to determine performance-based pay.

Many companies describe their compensation plans as "performance-based" and state they are designed to align the interests of management with those of the shareowners. However, some programs have not been adequately performance-based, resulting in excessive and abusive executive pay packages.

The Council is strongly supportive of enhanced qualitative disclosure of how plans are designed to be performance-based. We believe this is an area where current disclosures are lacking. One of the most critical elements of the SEC's proposal is how it addresses performance issues. The

proposed rules appropriately address some qualitative aspects of disclosure of links to performance. For example, the SEC proposes that a new Compensation Discussion and Analysis (CDA) section of the proxy statement would detail “what the program is designed to reward and not reward.” The CDA would also disclose how specific elements of compensation are structured to reflect items of the company’s performance and the executive’s individual performance.

However, another important element of performance-based disclosures is the quantitative measures used to determine incentive pay. Under current disclosure rules, companies are not required to disclose these performance hurdles or thresholds. This lack of disclosure is a major impediment to the market’s ability to analyze and understand executive compensation programs and to appropriately respond. Unfortunately, the SEC’s proposal would allow companies to exclude key information regarding performance targets and thresholds if the disclosure might be competitively harmful. The Council believes this approach provides too large an exemption for companies, ultimately leading to omission of valuable information.

The Council recommends an alternative under which companies would disclose actual performance targets either: (1) at the time they are established; or (2) at a future date—such as when the performance related to the award is measured—in cases when companies believe this information is competitively sensitive. If disclosure is postponed to a future date, the Council recommends that a company be required to explain that it is taking advantage of this exemption and the basis for taking this action.



The Council notes that provisions of H.R. 4291 that would require disclosure of short- and long-term performance measures used by companies to determine the compensation of executive officers are consistent with Council policy. The Council encourages the Committee on Financial Services and the SEC to work together to ensure shareowners are provided full disclosure of all performance criteria, including quantitative metrics and thresholds required to achieve payment.

#### **Director Accountability**

The board of directors, which is “elected” by shareowners to represent them and to oversee corporate strategy, monitor management performance and set executive compensation—is the cornerstone of the U.S. model of corporate governance. However, as compensation practices and other governance failures have repeatedly demonstrated, there are weaknesses in this model. We believe increasing the level of accountability of directors, including compensation committee members, to owners would strengthen the U.S. corporate governance model and would help rein in excessive or poorly structured executive pay packages.

The Council believes the accountability of directors at most U.S. companies is weakened by the fact that today shareowners do not have a meaningful vote in director elections. Under most state laws directors are elected by a plurality voting standard, which means that a director is elected in an uncontested situation even if a majority of the shares are withheld from the nominee. The Council considers plurality voting a fundamental flaw in the U.S. corporate governance system. This weakness has a direct impact on the issue of executive compensation by insulating directors from meaningful shareowner oversight. We believe moving to a majority

vote standard in the U.S. would have a demonstrable positive impact on the dynamics of compensation practices and director accountability for executive compensation decisions.

The Council recommends the Committee on Financial Services consider this important issue.

#### **Shareowner oversight**

A key responsibility of the compensation committee is to provide in the annual proxy statement clear disclosure of the company's compensation philosophy. The Council believes best practices also include shareowner approval of fully articulated, non-boilerplate compensation philosophies. Benefits to shareowners and companies of such approval would include:

- Enhancing the accountability of directors to shareowners, thereby increasing the sensitivity of boards to long-term shareowner interests;
- Providing owners with an appropriate role in approving broad policy parameters by which companies would implement and operate executive compensation programs;
- Providing a baseline for evaluating the effectiveness of executive compensation programs over time;
- Reinforcing a comprehensive and long-term view of the executive compensation program and improving communication between boards and shareowners; and,
- Reducing the instances in which the company and its shareowners are surprised by outcomes related to the compensation program, thereby reducing the negative reaction in the marketplace to specific events.

Because such an approval requirement would improve communication between compensation committees and shareowners and heighten director sensitivities to the interests of shareowners, the Council believes these items would rarely receive a majority “no” vote. The experience in the United Kingdom, where shareowners have an advisory vote on the annual remuneration report, supports the Council’s contentions. This advisory vote also ensures that a negative vote does not impede a company’s ability to compete for executive talent and compensate executives.

Since the Council is currently studying this issue to determine whether and how to best require such an approach in the U.S., the Council has no current position on the provision in H.R. 4291 to require shareowner approval of overall executive compensation plans. The Council does consider this approach a best practice.

#### **Disgorgement**

A Council policy calls for executives to be required to repay incentive compensation to the company in the event of malfeasance involving the executive, or fraudulent or misleading accounting that results in substantial harm to the corporation. This Council policy is strengthened by Section 304 of the Sarbanes-Oxley Act, which gave additional authority to the SEC to recoup bonuses or other incentive-based compensation in certain circumstances.

The Council notes that H.R. 4291 would require companies to adopt and disclose policies regarding disgorgement. Such an approach would supplement the Council’s policy and Section

304 of the Act and give companies the flexibility to establish and disclose whether disgorgement should address a broader set of executive officers. H.R. 4291 would also cover cases where performance-based compensation may be “unearned” in retrospect but not meet the high standard of “resulting from misconduct” required by Section 304.

The Council encourages the Committee on Financial Services and the SEC to work together to ensure that the final SEC rules require disclosure of disgorgement policies.

#### **Conclusion**

The Council is strongly supportive of the SEC’s proposed executive compensation disclosure rules, and we believe the Committee on Financial Services and the SEC should work together to ensure that final revisions to the executive pay disclosure rules address the issues raised in H.R. 4291.

## Special Comment

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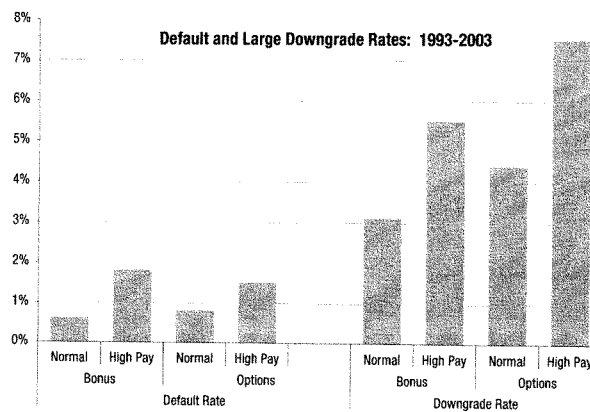
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## CEO Compensation and Credit Risk

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**Moody's Investors Service**  
Global Credit Research

## Summary

We examine the empirical relationship between executive compensation and credit risk. For each of the three major components of CEO compensation – salary, bonus, and stock option awards – we derive estimates of “unexplained” compensation as pay that deviates substantially from expected pay based on firm size, past performance, and other variables. We then relate these measures of unexplained compensation to the risk of default and large rating downgrades between 1993 and 2003.

After controlling for a variety of firm characteristics, including industry effects and long-term ratings, we find that large, positive, unexplained bonus and option awards are predictive of both default and large rating downgrades. Variations in salaries, however, do not appear to be predictive of credit risk.

Although the analysis does not directly address the reasons why large bonuses or option grants are associated with greater credit risk, possible explanations can be inferred from the academic literature on CEO compensation, managerial incentives, and board control.

High levels of unexplained compensation may indicate that board oversight is lax and, as a result, management has insufficient pressure to deliver good financial performance.

Large performance-based compensation packages, in particular, may induce managers to:

- Deliver strong short-term financial results and obscure longer-term structural problems.
- Pursue high risk strategies with very strong positive, but also very adverse, potential payoffs.

## The Link Between CEO Compensation And Credit Risk

This *Special Comment* investigates the empirical relationship between the size of a CEO's pay package – compared to its expected value as determined by a simple compensation prediction model – and credit risk, as measured by default rates and the frequency of large rating downgrades. To our knowledge, this is the first empirical research to focus on CEO compensation and realized credit risk, although there is an extensive theoretical literature that relates compensation to managerial incentives and a large empirical literature that relates compensation to realized equity returns.

CEO compensation schemes are designed to provide incentives to induce superior managerial performance, consistent with shareholder objectives. Although base salaries tend to be fairly insensitive to firm performance, bonus payments are often tied directly to operating performance through specific formulas, and option grants reward strong expected future operating performance that leads to higher stock prices.

Large compensation packages may be a signal, however, that a CEO has undue influence over his or her board of directors. As a result, the expected incentive effects of the compensation package may be ineffective because the CEO can obtain high compensation despite mediocre performance. Evidence that compensation is larger than expected may, therefore, be predictive of poor performance, both from the perspective of equityholders and debtholders.

It is also possible that equityholders and debtholders may view large levels of incentive-based bonus and options differently. Stockholders generally want firm managers to pursue all positive expected value projects – even if they are risky – because stockholders benefit from limited liability and a residual claim on the firm's assets and they can diversify their holdings across firms. Debtholders, on the other hand, would generally prefer managers to pursue less risky strategies. Since incentive compensation is intended to align manager incentives with stockholder interests, it is reasonable to expect that higher levels of incentive pay (at least based on shareholder-oriented metrics) would be correlated with greater credit risk.

Compensation that is highly sensitive to short-term financial performance may also create incentives for CEOs to manipulate short-term measures of firm's performance – even if such manipulation adversely affects the firm's long-term performance. For example, if the CEO's bonus depends entirely on operating income, the individual has an incentive to adopt aggressive accounting practices to maximize short-term financial results, even if in so doing, long-term financial performance is compromised.<sup>1</sup> It is also possible that managers alter actual operations in ways that hurt the firm in the long term or increase event risk. Examples of this could include cutbacks, by a utility with nuclear

1. Prior academic research has shown that large executive stock option grants have been associated with accounting restatements and fraud. Specifically, the research showed that there was little relationship between salary and the announcement of an SEC forced restatement, including those related to fraud, or the announcement of a class action law suit proclaiming securities fraud. The relationship between these events and the size of the bonus is always positive but rarely significant. Only stock-based incentives were found to be significantly and positively related to the occurrence of a negative event. (For accounting restatements and fraud, see the papers by Erickson et al or by Johnson, et al. For class action lawsuits, see the paper by Denis, et al.) While previous research shows a relationship between option incentives and certain negative events, the focus on these negative events makes it difficult to determine whether option incentives only increase the likelihood of fraud or also increase the overall risk of the firm. It is quite possible that the accounting fraud comes about due to managers' attempts to cover up randomly bad results from good but risky projects. Some previous research shows that higher option incentives are related to better firm performance on average lending some credence to this hypothesis. (See, for example, the paper by Hillegeist and Penava.)

power plants or by an airline, of the ordinary maintenance and repair budget to the bone, or bank cutbacks on internal audit. Larger than expected compensation may also be correlated with higher levels of credit risk if it signals weak oversight from the board of directors. Strong board oversight may be an important safeguard against the risk that management will pursue uneconomic projects that might endanger the firm's future.

## The Data Set

We focus exclusively on non-financial corporations in the United States with senior unsecured bond ratings of B3 or higher, from 1993 through 2003. An "observation" for each firm in a year includes its rating at the beginning of the year, a dummy variable indicating whether the firm defaulted within the next twelve months, and another dummy variable indicating whether the firm experienced a "large" rating downgrade of three or more refined rating notches during the subsequent year.

Each observation also includes the three major components of the prior year's CEO compensation – salary, bonus, and stock-based incentive compensation. Stock-based compensation includes both restricted stock grants and executive stock options. However, due to the preponderance of options versus stocks within our sample period, we will refer to this component of compensation as simply "option" compensation throughout the remainder paper. While we expect there could be differences in the incentives caused by stocks and options, we do not test for these in this study. In addition, we track firm revenues and operating income during the prior year, market capitalization at the beginning of the year, CEO tenure in years, and a number of other firm financial performance measures. The financial data is drawn from Compustat, and the compensation data comes from Execucomp.

Altogether, we have 4,485 annual observations on a total of 865 unique firms, with an average of 5.2 annual observations on each firm.<sup>2</sup> Among these firms, 43 or 1.0% defaulted during the sample period, and 214 or 4.8% incurred "large downgrades," which we define as a change in three or more refined rating notches within any twelve-month period. (Firms can experience more than one large rating change within the twelve-year sample period.)

## Modeling Compensation

To determine unexplained compensation, we develop a model that predicts expected salary, expected bonus, and expected option grants based on firm size, past operating performance, CEO tenure, and industry – variables selected from the academic literature on CEO compensation.<sup>3</sup> We also include annual dummies to account for the fact that compensation levels rose steadily through the sample period. We estimate three related regression models – one for each of the three major components of compensation. However, we use a regression technique that takes into account the fact that the determinants (both included in and excluded from the model) of compensation are likely to be correlated across the components.<sup>4</sup>

Selecting the timing relationships between the explanatory and dependent variables requires some care. Once executive compensation data are made publicly available, in most cases the actual compensation decisions have been set for over a year. For example, the most recent proxy statement for Moody's Corporation was publicly released on March 23, 2005, and reported CEO salary, option grant, and bonus data for 2004. The salary was determined based on fiscal year 2003 performance and was paid out over fiscal year 2004. The option grant was also based on fiscal year 2003 performance and was awarded in February of 2004. The targets for the 2004 bonus were set in light of the fiscal year 2003's performance, but the actual payout was based on fiscal year 2004's performance. Our models for salaries and options are, therefore, based on data lagged by one year; however, our model for determining bonuses requires data spanning two years – the year for which the targets were set and the year over which performance was measured.<sup>5</sup> This will likely bias the results of our studies against finding any results because we will be predicting performance

2. Observations pertaining to CEOs with tenures of less than one year were removed from the sample because firms in distress often pay larger amounts to new CEOs as an incentive to turn the firms around. If we had included these observations in the sample, we might have concluded that high compensation predicted credit risk, when the relevant compensation for predicting credit risk was really the package received by the prior CEO.

3. See, for example, the survey on executive compensation by Murphy (1998).

4. In particular, we obtain our coefficient estimates results using a seemingly unrelated regression ("SUR") model that adjusts for correlation between the variables. The appropriateness of the SUR approach was confirmed by the correlation matrix of the residuals from the first-stage regression which indicated positive correlations – salaries and bonuses at 20.7%, salaries and options at 3.5%, and bonuses and options at 7.5%. The regressions were estimated on a weighted basis, where the reciprocal of the natural log of revenues was used as the weight, because compensation shocks to firms with large revenues are likely to be larger than those of other firms. The regressions were run as panels. Since the standard t-statistics associated with panel regression coefficient estimates are likely to be biased upward due to persistent shocks to individual firms, we calculated the t-statistics reported in Table 1 using regression residuals each year and averaging. Calculating the t-statistics in this way is biased downward – rather than upwardly biased as in the standard model.

5. There are complications here, for example that in many cases the bonus award will be based less on a pre-set formula and more on subjective determinants. There are other variations from the standard pattern assumed here, creating some noise around the results. However, we believe our timing assumptions are true for most companies included in the study. The likely effect of firms using different timing patterns on our results will be to create a bias against finding any relationship between pay and credit risk.

over the next year using year-old data.<sup>6</sup> For simplicity, the fiscal year immediately prior to the proxy report will be called the “current” year, the year prior to that will be called “previous” year, and the following year for which we are forecasting credit behavior will be called “next” year.

Exhibit 1 presents the estimated empirical determinants of the components of compensation. The estimates are consistent with our expectations. Larger firms – measured either by revenues or market capitalization – pay more. Firms with higher operating income pay more. CEOs with longer tenures receive more pay. Variations in CEO salaries are well explained by our model, as evidenced by the high adjusted- $R^2$  of 47.4%. Firms tend to be less uniform in their methods for assigning bonuses (adjusted- $R^2$  of 21.1%) and even less predictable with their assignment of stock option grants (adjusted- $R^2$  of 5.3%). While the model may not perform well in predicting any individual firm’s assignment of options for a given year, the model does appear to correctly flag companies whose option payouts exceed expectations based on firm size, past performance, and industry.

<b>Exhibit 1 Determinants of the CEO Compensation</b>			
Explanatory Variables	Dependent Variables		
	Salary	Bonus	Options
<i>variables from the previous year</i>			
Log of Sales	83.51 (4.95)	114.23 (2.04)	(249.37) (0.64)
Log of Market Capitalization	27.65 (1.87)	47.99 (1.02)	1193.41 (3.37)
Operating Income	0.08 (7.45)	0.22 (6.39)	1.65 (6.30)
<i>variables from the current year</i>			
Log of Sales		243.55 (0.70)	
Log of Market Capitalization		231.52 (1.02)	
Operating Income		0.59 (4.37)	
CEO Tenure (in years)	5.98 (3.16)	3.74 (0.62)	4.25 (0.10)
Adjusted - $R^2$	47.4%	21.1%	5.3%
Notes: 1. Sample consists of 4,485 annual observations covering 865 unique firms. 2. Regressions were estimated using a seemingly unrelated regression model, and residuals were weighted by inverse of firm revenues. 3. Absolute t-statistics in parentheses indicate significance of estimated coefficients for the panel data but is derived by averaging across annual t-stat estimates derived using the residuals from the SUR for each annual cohort. 4. Regressions include year, industry, and ratings dummies (not reported).			

CEO salaries are typically benchmarked to the logarithm of firm size, usually measured by sales. Bonuses and stock incentives are typically benchmarked to salary and other performance measures. In our model, the logarithm of sales is highly significant for salary but not statistically significant for bonus or option incentives. The negative coefficient for option incentives might indicate that many smaller firms issue large amounts of options.

Market capitalization is statistically and economically significant for salaries and stock-based incentives. The positive result for salaries may indicate that some firms use the stock market in their assessment of firm size. The size of the coefficient for options is many times larger for stock-based incentives than it is for salaries and bonuses. This might indicate that firms that issue executive stock options focus more on stock performance and therefore have high market capitalizations given their revenue size.

Last year’s operating income is statistically and economically significant for all compensation components. While firms that have performed well may give their employees large one-time bonuses, they will often also reset overall levels of future compensation. This is demonstrated by the increase in salaries and the very large increase in stock option grants.

We also considered other potential explanatory variables, such as changes in working capital, leverage, total assets, cash, quick ratio, net income, return on assets, and the previous year’s rating actions. None was found to be significant when included with those listed in Exhibit 1. Industry dummies were included in the regression but are not presented.

6. The variables for the second year are measured as the positive increase over the previous year because we envision that firms do not set negative bonus targets. CEOs that do not create a positive performance in the second year are expected to get no bonus.



With a model now in hand that explains variations in CEO compensation, it is possible to identify the gap between actual compensation and predicted compensation as “unexplained” compensation (which when negative, should be interpreted as “unexpectedly” low compensation). Because this is a model-based measure of unexplained compensation, many of the compensation packages identified as unexplained can presumably be explained in a straightforward manner by analysts who are well acquainted with the circumstances. Nevertheless, we believe that these models are successful in identifying many of the cases of unusually large and unusually low levels of executive compensation.

Examples of firms caught by the model that ultimately defaulted include Covanta Energy and Enron, both of which defaulted in 2001. Covanta Energy was marked by the model as having high unexplained compensation in six of the seven years prior to its default. Enron was also marked as providing high unexplained compensation in six of the seven years prior to its default.

While a higher number of firms with larger than expected compensation experienced a credit event than would otherwise have been expected, not every firm with larger than expected compensation is necessarily a higher credit risk. The vast majority of these firms never experienced a default or a large downgrade during our sample period. Instead, using compensation as a signal judiciously with other factors may help to highlight the effectiveness of a firm's governance practices.

### Default Rates, Downgrade Rates, And Unexplained Compensation

In order to compare the degree of deviations from expectation across firms, we normalized unexplained compensation by its predicted value; i.e., unexplained compensation is expressed as a percentage deviation from the predicted level of compensation.<sup>7</sup> We then measure annual default rates and downgrade rates for various subgroups of the population. We focus on “large” downgrade rates, defined as a downgrade of three or more refined rating notches with a year, with the particular objective of measuring financial distress at investment-grade firms, which are less likely than speculative-grade firms to default.<sup>8</sup>

The results for various percentile stratifications of the compensation distributions for the full dataset (including both investment-grade and speculative-grade firms) are presented in Exhibit 2. To determine a firm's position in the distribution of unexplained compensation, the firms are sorted by the appropriate unexplained compensation each year and their position is marked. This is done for all three compensation variables. The sorting is done each year so as to avoid a situation where all of the outliers fall into one year. This maximizes the model's ability to determine whether it is possible to differentiate between firms in any given year.

Exhibit 2 Variation in Annual Default and Downgrade Rates across the Compensation Distribution						
Position in the Unexplained Compensation Distribution	Defaults Rates			Downgrade Rates		
	Salary	Bonus	Options	Salary	Bonus	Options
0% - 20%	1.0%	1.8%	1.1%	4.9%	10.3%	4.7%
20% - 40%	0.7%	1.2%	0.8%	6.0%	3.8%	4.5%
40% - 60%	1.1%	0.1%	0.7%	3.3%	3.0%	4.0%
60% - 80%	0.7%	0.6%	0.8%	4.5%	2.5%	4.9%
80% - 100%	1.3%	1.1%	1.4%	5.1%	4.3%	5.8%
20% - 90%	1.0%	0.6%	0.8%	4.7%	3.1%	4.4%
90% - 100%	0.9%	1.8%	1.5%	4.6%	5.5%	7.5%
Full sample		0.7%			4.8%	

The first point to notice is that there are no consistent patterns in the middle 60% of the distribution. All of the action appears in the bottom and top quintiles. Interestingly, companies that paid their CEOs the least in bonus compensation (the bottom 20%) experienced the highest default and downgrade rates. This perhaps initially surprising result is easily explained by reverse causality: poor prior performance probably led to low bonus compensation, rather

7. In order to ensure that the excess compensation measured on a percentage makes economic sense even when the model-derived measure of expected compensation is negative and or positive but close to zero, we truncated expected compensation used in the denominator of this measure at a small but positive number. In particular, we assumed in these cases that the denominator took the value of compensation observed by the highest earning CEO within the bottom decile of the population, i.e., \$400,000, \$200,000, and \$40,000 for salaries, bonuses, and stock-based incentives, respectively.

8. Although not reported, we also correlated excess compensation with upgrade rates and generally found no systematic relationship. This finding is unsurprising because upgrades for improved financial performance are normally gradual over time, with at most two rating notch increases per year. Large rating upgrades typically occur when a weaker company is acquired by a stronger company, which often follow (ironically) from deterioration in weaker company's stand-alone credit risk.

than the reverse. To determine the truth of this hypothesis, we looked at the historical sales growth and the historical operating income growth for the overall sample and for the firms in the lowest unexplained bonus quintile. In the previous fiscal year, the low bonus companies experienced an average decrease in operating income of 20% compared to an average increase of 8.8% per year for the overall sample. The average decrease in the current year was 38%. The poor operating income performance for these companies indicates that these companies would have already been considered to be in distress and the CEO compensation information was likely to provide little additional information.

The more interesting result occurs at the other end of the distribution, in the top 10%.<sup>9</sup> Firms with high unexplained bonuses and high unexplained option grants experienced dramatically higher default rates and dramatically higher downgrade rates than did the middle 70% of the distribution. The firms in the upper tail experienced operating income growth of 3.0% in the previous year and 13.1% in the current year. A superficial analysis would not likely flag these companies as being in trouble and yet their default rates were between two and three times higher than the middle ranked firms. Downgrade rates were almost two times higher.

Exhibits 3 and 4 detail the effects of unexplained compensation on default and downgrade rates by rating category. These exhibits reveal that default and downgrade rates are strikingly larger for investment-grade firms (particularly Baa-rated firms) that pay high bonuses or high option grants. Adverse credit implications of high incentive pay are also evident for Ba-rated firms. The results are much weaker for B-rated firms but still directionally consistent with the other rating categories.

<b>Exhibit 3</b>									
<b>Annual Default Rates by Rating and Position Within the Unexplained Compensation Distribution</b>									
	Salary			Bonus			Options		
	Bottom	Middle	Top	Bottom	Middle	Top	Bottom	Middle	Top
	20%	70%	10%	20%	70%	10%	20%	70%	10%
Aaa-Aa	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
A	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Baa	0.0%	0.6%	0.0%	0.3%	0.1%	2.5%	0.7%	0.2%	1.6%
Ba	0.4%	1.6%	0.9%	3.0%	0.3%	2.8%	0.9%	1.3%	1.9%
B	7.7%	4.7%	4.1%	6.7%	5.3%	2.0%	5.6%	5.7%	3.5%
Investment Grade	0.0%	0.3%	0.0%	0.2%	0.0%	1.4%	0.4%	0.1%	0.8%
Speculative Grade	2.6%	2.6%	2.1%	4.3%	1.9%	2.5%	2.4%	2.6%	2.6%
All Firms	1.0%	1.0%	0.9%	1.8%	0.6%	1.8%	1.1%	0.8%	1.5%

<b>Exhibit 4</b>									
<b>Annual Large Downgrade Rates by Rating and Position Within the Unexplained Compensation Distribution</b>									
	Salary			Bonus			Options		
	Bottom	Middle	Top	Bottom	Middle	Top	Bottom	Middle	Top
	20%	70%	10%	20%	70%	10%	20%	70%	10%
Aaa-Aa	6.0%	1.8%	0.0%	7.0%	2.2%	0.0%	3.6%	2.4%	3.7%
A	2.2%	3.8%	4.3%	8.5%	2.2%	6.0%	2.7%	2.4%	6.3%
Baa	5.5%	5.2%	4.2%	12.1%	3.0%	5.7%	4.5%	4.6%	11.3%
Ba	5.4%	5.7%	6.2%	11.3%	3.8%	4.6%	6.2%	5.5%	5.8%
B	7.7%	6.4%	5.4%	8.3%	5.6%	8.0%	6.5%	6.4%	7.0%
Investment Grade	4.2%	4.3%	3.8%	10.4%	2.5%	5.4%	3.7%	3.8%	8.4%
Speculative Grade	6.1%	5.9%	5.9%	10.3%	4.4%	5.7%	6.3%	5.8%	6.3%
All Firms	4.9%	4.7%	4.6%	10.3%	3.1%	5.5%	4.7%	4.4%	7.5%

9. We also examined using the top 5% of the distribution as the tail. The results were somewhat stronger. Consistent with our methods throughout this study, we decided to present conservative results where possible.

## Regression Results Also Show Incentives Are Associated With Default Risk and Downgrade Risk

Exhibit 5 shows the results of two probit regressions. The first predicts default and the second large downgrades. The purpose of the regression is to determine whether the results presented in the previous tables could be due to industry effects. It will also help answer the question of whether bonuses or option grants are more important for determining credit risk. Specifically, it is possible that one or the other drives the results but that correlation between the two makes it seem that each is important when looked at individually. The equation used in a probit regression is:

In other words, the probability of a credit event is equal to the normal distribution of a constant and a series of factors. In this case, the constant and the factors are listed in the first column of exhibit 5. These models are often used for credit event prediction because the predicted probability is always constrained to be between zero and one. Unlike a standard linear regression, though, it is more difficult to interpret the resulting coefficients as probit coefficients are measured in standard deviations instead of slopes. For example, in the default regression, if a company is listed as having high unexplained bonus, then  $?????x$  is increased by 0.42 standard deviations. The measure of goodness of such a regression is the 'percent concordant' or, equivalently, the percentage of companies correctly flagged as defaulting or not defaulting.

Recent downgrade rates are highly significant and important predictors in both regressions and have the expected signs.<sup>10</sup> It is well known that defaults often follow downgrades. It is less well known that rating migrations often follow previous migrations. This effect is called rating momentum and has been attributed to many causes.

As expected, firms with low bonuses were more likely to experience downgrades and/or defaults. Surprisingly, though, this did not hold for firms with low option payouts. The coefficients on the dummies for low option payouts are very close to zero, both economically and statistically.

High bonus payouts are significantly related to the probability of downgrade and/or default. The results for option payouts are weaker but significant. This could either reflect the older data used to predict option payouts versus that used to predict bonus payouts or it could indicate that bonuses are simply more important for determining the performance of a company.

Exhibit 5: Probit Regression Results			
		Defaults	Large Downgrades
		coefficient	coefficient
Intercept		-6.71 ***	-2.55 ***
Recent Downgrade Rate		0.57	0.68 ***
Salary			-0.08
	Bottom 20%	0.00	-0.11
	Top 10%	-0.13	
Bonus			0.49 ***
	Bottom 20%	0.29 ***	0.30 ***
	Top 10%	0.42 ***	
Option Grants			-0.01
	Bottom 20%	0.07	0.19 **
	Top 10%	0.13	
Percent Concordant		83.4	81.2
Dummies representing the annual cohort year, industries, and ratings were suppressed for presentation purposes			

10. Downgrade rates take a value of one if there was a downgrade in the past year, negative one if there was an upgrade, and zero if there were no rating changes or if there was both an upgrade and a downgrade.

## Conclusion – Excessive Compensation Packages Are Associated With Higher Levels Of Credit Risk

This Special Comment provides evidence that a connection exists between CEO compensation and overall credit risk. Firms where CEO pay is substantially greater than expected based on firm size, past performance, and other variables experience higher default rates and more frequent large downgrades than do other similarly rated companies.

The research presented here does not, however, explain why higher compensation may be associated with higher credit risk. At least three possible explanations can be inferred from the literature. One, excessive compensation may be indicative of weak management oversight. Two, large pay packages that are highly sensitive to stock price and/or operating performance may induce greater risk taking by managers, perhaps consistent with stockholders' objectives, but not necessarily bondholders' objectives. Three, large incentive-pay packages may lead managers to focus on accounting results, which may, at best, divert management attention from the underlying business or, at worst, create an environment that ultimately leads to fraud.

The correlation we have observed between unexplained compensation and credit risk is based on historical data and may not be constant over time. Developments in the areas of CEO compensation and board oversight may be altering both the time horizon and the risk-return characteristics of management incentives along with the behaviors that they encourage. For example, the use of option grants grew from almost nothing to become the primary method for compensation. More recently, awards of performance shares and restricted stock have gained prominence. Firms will likely continue to experiment with new vehicles intended to induce superior managerial performance. Also, firms often argue that weak industry conditions accentuate the need to retain and motivate capable managers through retention awards and related vehicles and that this is intended to serve both shareholder and bondholder interests. Therefore, even though the model could provide valuable early-warning information in terms of assessing potential credit problems, analysts should also evaluate the relationship between CEO compensation and expected credit risk on a case-by-case basis.

## Related Research

### Special Comments:

Takeover Defenses and Credit Risk, December 2004 (89713)

Moody's Findings on Corporate Governance in the U.S. and Canada, October 2004 (89113)

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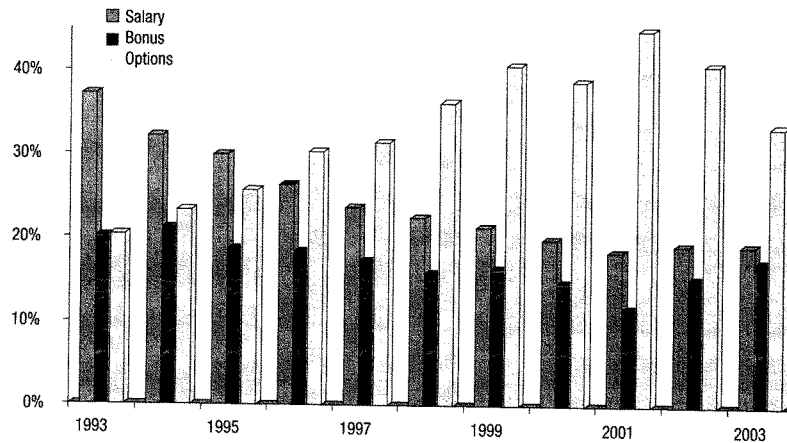
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## Appendices

### A. Characteristics of the Data

The potential for incentives to affect firm performance has been increasing over the past decade due to significant increases in the size of incentive compensation. The non-incentive portion of compensation, salary, has decreased from 38% of total compensation in 1993 to only 19% in 2003 (Exhibit 1.) While bonuses have decreased as a percentage of total compensation (20% to 18%) they have significantly increased in relation to salary. The largest increase in incentive pay has come from the growth in executive stock options grants. They grew from a relatively small part of overall compensation to become by far the most significant component.

**Exhibit A1: Median Share of Compensation**



### B. Aggregate Downgrade, Upgrade, and Default Rates for Moody's Corporate Bond Issuers

If the probability of a credit event did not depend on rating category, we would not need to control for ratings in our tests. Exhibit B1 shows that the probability of a credit event increases monotonically from higher ratings to lower ratings and so we need to control for ratings in all any test that we conduct. In other words, lower rated firms are in all ways more volatile.

**Exhibit B1: Credit Risk 1990 - 2003**

	Downgrades	Upgrades	Defaults
Aaa	1.71%	0.00%	0.00%
Aa	2.13%	0.21%	0.00%
A	2.40%	0.10%	0.00%
Baa	3.67%	0.94%	0.27%
Ba	6.10%	1.78%	1.53%
B	6.39%	2.21%	5.11%

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